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IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

HOOVER & BRACKEN ENERGIES, INC.
Petitioner,

v.

UNITED STATES DEPARTMENT OF THE INTERIOR, *et al.*,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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May 3, 1984

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QUESTIONS PRESENTED FOR REVIEW

The Natural Gas Policy Act of 1978 ("NGPA") imposed wellhead price controls on natural gas by prescribing a system of "maximum lawful prices" for all "first sales" of natural gas, effective December 1, 1978. The NGPA further provided in Section 110 that a price for the first sale of natural gas shall not be considered to exceed the applicable maximum lawful price if such price exceeds the applicable maximum lawful price "to the extent necessary to recover . . . State severance taxes attributable to the production of such natural gas and borne by the seller . . . ." The Secretary of the Interior claimed, as royalty on natural gas produced from federal and restricted Indian lands under departmental leases held by petitioner, a portion of the state severance tax reimbursement made in accordance with NGPA Section 110 by the purchaser of petitioner's gas, *notwithstanding that the federal and Indian royalty share of the gas was exempt from the levy of state severance tax and no severance tax attributable to such royalty interest was paid or reimbursed.*

The questions presented for review are:

1. Whether the Secretary of the Interior lawfully may interpret and apply Department of the Interior regulations governing the calculation and payment of royalties on natural gas produced from federal and restricted Indian lands in a manner which prevents the private lessee of such lands from realizing the full amount of the ceiling price applicable to such gas under the NGPA.

2. Whether the Secretary of the Interior lawfully may claim as royalty on natural gas produced from federal and restricted Indian lands a portion of the amount paid by the purchaser of such natural gas as a reimbursement of state severance taxes levied on the lessee's share of production.

3. Whether a determination by the Secretary of the Interior that the value for royalty purposes of natural gas produced from federal and restricted Indian lands lawfully may exceed the ceiling price applicable to such gas under the NGPA should be accorded great deference by a reviewing court.

4. Whether the Secretary of the Interior, in requiring that gas royalty payments under leases of federal and restricted Indian lands be calculated based upon a method of determining "value" which is affected by such factors as the identity of the seller, the tax jurisdiction in which the lands are situated and the percentage of federal or Indian lands included within the particular producing unit, acted in a manner which is arbitrary, capricious or otherwise contrary to law.

PARTIES TO THE PROCEEDINGS

The petitioner in this case is Hoover & Bracken Energies, Inc.* The respondents herein are the United State Department of the Interior, the Secretary of the Interior, the Director of the United States Geological Survey, and the Commissioner of the Bureau of Indian Affairs.

**Effective December 1, 1983, the name of the corporation was changed to Bracken Energies, Inc.; however, to facilitate identification of the petitioner herein as the same corporation as the party to the proceedings below, all references to the petitioner will be to Hoover & Bracken Energies, Inc. Bracken Energies, Inc., an Oklahoma corporation, is a wholly-owned subsidiary of Bracken Exploration Company, a Delaware corporation. Affiliated corporations are BNC Corporation, an Oklahoma corporation, and Watrous Airlines, Inc., an Oklahoma corporation, both of which are wholly-owned subsidiaries of Bracken Exploration Company.*

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C. Decision of the Acting Director, USGS, and the Acting Deputy Commissioner, BIA, dated November 29, 1979, Case Nos. GS148-O&G and IND20-O&G

D. Decision of the Interior Board of Land Appeals dated January 5, 1981, IBLA Case No. 80-305, *Hoover & Bracken Energies, Inc.*, 52 IBLA 27 (1981)

E. Memorandum Opinion filed November 18, 1981, in the United States District Court for the Western District of Oklahoma, Case No. CIV-81-461-T, *Hoover & Bracken Energies, Inc. v. United States Department of the Interior, et al.* (unreported)

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Petitioner, Hoover & Bracken Energies, Inc., respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Tenth Circuit entered in this case on December 28, 1983.

OPINIONS AND ORDERS BELOW

The decision of the United States Court of Appeals for the Tenth Circuit (App. A) is reported at 723 F.2d 1488 (10th Cir. 1983) (2-1 decision, Seth, C.J., dissenting). The order denying rehearing and rehearing *en banc* (4-3 vote, App. G) is not reported.

The decision of the United States District Court for the Western District of Oklahoma (App. E) is not reported.

The decision of the Interior Board of Land Appeals (App. D) is reported at 52 IBLA 27 (1981). The decision of the Acting Director, United States Geological Survey, and the Acting Deputy Commissioner, Bureau of Indian Affairs (App. C) is not reported.

JURISDICTION

The judgment of the court of appeals (App. A) was entered December 28, 1983. The court of appeals denied a timely petition for rehearing on February 3, 1984, and this petition for certiorari was filed within 90 days after such date. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. §1254(1).

STATUTES AND REGULATIONS INVOLVED

Natural Gas Policy Act of 1978, 15 U.S.C. §§3301-3432 (Supp. V 1981).

Section 110(a) of the Natural Gas Policy Act of 1978, 15 U.S.C. §3320(a) (App. H).

30 C.F.R. §221.47 (1982)[1] (App. I).

25 C.F.R. §172.1[illegible] (1981)[2] (App. J).

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[1]This regulation was eliminated effective August 12, 1983, 48 Fed. Reg. 36582 (1983).

[2]This regulation has been redesignated as 25 C.F.R. §212.16 (1983).

STATEMENT OF THE CASE

Hoover & Bracken Energies, Inc. ("H&B") is the lessee under several oil and gas leases covering federal and restricted Indian lands situated in the state of Oklahoma (the "Leases"). The Leases cover lands which have been communitized with privately owned lands for the purpose of forming drilling units to explore for oil and gas. These drilling units conform to the boundaries of drilling and spacing units established under state law. Generally only one well is drilled in each drilling and spacing unit, the costs of which are borne by each lessee in the proportion that the acreage covered by his lease bears to the total acreage in the unit. If production is obtained from the unit well, all of the lessees and royalty owners in the unit share in such production in accordance with the terms of their respective leases.

The state of Oklahoma imposes a severance tax on natural gas produced within the state equal to seven and eighty-five one thousandths percent (7.085%) of the gross value thereof.[3] The severance tax, although levied on and borne by the producer and the royalty owner, is required to be remitted by the purchaser of the natural gas directly to the Oklahoma Tax Commission.[4] The royalty share of gas produced from federal and restricted Indian lands, however, *is exempt* from the levy of the Oklahoma severance tax.[5]

The Natural Gas Policy Act of 1978 ("NGPA")[6] establishes ceiling prices for all natural gas produced and sold in the United States (with the exception of certain categories of high-cost natural gas not at issue herein). Section 110(a) of the NGPA[7] provides that the maximum

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[3] 68 Okla. Stat. §§1001, 1102 (1981).

[4] 68 Okla. Stat. §§1009(d), 1102 (1981).

[5] *See* 68 Okla. Stat. §§1008, 1106 (1981).

[6] 15 U.S.C. §§3301-3432 (Supp. V 1981).

[7] 15 U.S.C. §§3320(a) (Supp. V 1981).

lawful price applicable to any first sale of natural gas may be exceeded to the extent necessary to recover "State severance taxes attributable to the production of such natural gas and borne by the seller ..."

H&B has drilled or has joined with others in the drilling of a commercial natural gas well on each of the units hereinabove described and has executed a long term gas purchase contract covering the sale of natural gas produced from each such unit. Under each contract, the purchaser has agreed to pay the NGPA ceiling price applicable to the gas, and has agreed to reimburse all state severance taxes levied on the gas prior to delivery. Because the federal and restricted Indian royalty share of production under the Leases is not subject to the payment of state severance taxes, tax reimbursement by the purchaser is limited to the non-tax exempt portion of production.[8]

Substantial volumes of natural gas have been produced and sold from the lands covered by the Leases. Prior to the decision of Interior at issue herein, the proceeds of such sales were accounted for as follows. The purchaser of the gas remitted to the Oklahoma Tax Commission, in the manner prescribed by law, the amount of severance tax due on the non-tax exempt portion of production. At the same time, the purchaser paid to H&B, in accordance with the terms of the gas purchase contract, the NGPA ceiling price applicable to the gas sold. H&B then proceeded to pay the royalty due under the Leases based upon the NGPA ceiling price received from the purchaser. As a result of this procedure, H&B and the lessors under

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[8]NGPA §110(a) provides that the applicable ceiling price may be exceeded only to the extent of state severance taxes levied on the gas which are "borne by the seller." Inasmuch as the federal and Indian royalty share of production is exempt from the levy of the Oklahoma severance tax, the purchaser may not pay any amount in excess of the applicable NGPA ceiling price with respect to such royalty share of production.

the Leases received exactly the same price, *i.e.*, the applicable NGPA ceiling price (exclusive of severance tax), for their respective portions of the gas sold.[9]

By letter dated June 14, 1979 (App. B), the Area Oil and Gas Supervisor (the "Supervisor"), United States Geological Survey ("USGS"), Tulsa, Oklahoma, notified H&B that H&B's practice of calculating and paying royalties under the Leases based upon the NGPA ceiling price actually received by H&B was not in accordance with applicable Department of the Interior regulations and the royalty provisions of the Leases for the reason that such royalty payments were not based upon the "gross value" of the gas sold. The Supervisor's letter stated that in calculating the gross value of the gas for royalty purposes, the amount of any tax reimbursement paid by the purchaser for the non-tax exempt interests must be taken into account. The letter also demanded payment for past and future royalties calculated accordingly.[10]

H&B appealed the Supervisor's determination to the Acting Director, USGS, and to the Acting Deputy Commissioner, Bureau of Indian Affairs ("BIA"). The appeal was denied by decision of the Acting Director, USGS, and the Acting Deputy Commissioner, BIA, on November 29, 1979 (App. C). H&B appealed such decision to the Interior Board of Land Appeals ("IBLA"), and on January 5, 1981, the IBLA affirmed the USGS-BIA decision upholding the Supervisor's determination (App. D).

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[9]Lessors and lessees of private lands communitized with the federal and Indian lands covered by H&B's leases also received the NGPA ceiling price (exclusive of severance tax) applicable to the gas sold.

[10]The effect of the Supervisor's determination, later affirmed by the Interior Board of Land Appeals, is to require H&B to pay gas royalties under the Leases based upon a "value" which includes a tax reimbursement component not received by H&B for the royalty share of production. As a result, the federal and Indian lessors receive *more* than the NGPA ceiling price for their royalty share of production while H&B realizes *less* than the NGPA ceiling price for its working interest share of production.

The IBLA decision was based almost entirely on its previous decision in *Wheless Drilling Co.*,[11] a case involving a similar dispute regarding calculation of royalty payments under departmental leases where the lessee received reimbursement of state severance taxes. In denying H&B's appeal, the IBLA considered the principles announced in *Wheless* to be controlling notwithstanding the subsequent enactment of the NGPA. The IBLA concluded that all relevant factors affecting the value of the gas for royalty purposes had been considered by the USGS and the BIA and that the decisions of such agencies should be affirmed.

On April 3, 1981, H&B filed in the United States District Court for the Western District of Oklahoma an action seeking judicial review of the IBLA decision and declaratory relief relating to the royalty value issue. The jurisdiction of the district court was invoked under Section 10 of the Administrative Procedure Act, 5 U.S.C. §§702-706, and under 28 U.S.C. §§1331, 1361, 2201, and 2202. On November 18, 1981, the district court entered its Memorandum Opinion (App. E) and Judgment (App. F) in favor of H&B and against the Department of the Interior, *et al.* (respondents herein), whereby the IBLA decision was rendered null and void. The district court held that the IBLA decision and the agency action which it affirmed are contrary to the intent and purpose of Congress in enacting the NGPA. The district court also held that Interior had exceeded its lawful authority in attempting to value the federal and Indian royalty share of production from the Leases at an amount in excess of the maximum lawful price applicable to such gas under the NGPA.

On January 15, 1982, the respondents herein appealed the district court decision to the United States Court of Appeals for the Tenth Circuit. On December 28, 1983, the court of appeals, in a 2 to 1 decision, issued its opinion

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[11]13 IBLA 21, 80 I.D. 599 (1973).

reversing the judgment of the district court (App. A). Chief Judge Seth filed a dissenting opinion (App. A-11). Thereafter H&B filed a timely petition for rehearing of the court of appeals' decision together with a suggestion for rehearing *en banc*. By order entered February 3, 1984, the petition for rehearing was denied by vote of 2 to 1 and the suggestion for rehearing *en banc* was denied by vote of 4 to 3 (App. G).

REASONS FOR GRANTING THE PETITION

I. The Decision of Interior Is Inconsistent With The Uniform Ceiling Price And Severance Tax Reimbursement Scheme Established By Congress Under The NGPA Because:

(a) Under Interior's Decision Lessees Of Federal And Restricted Indian Lands Are Prevented From Retaining The Full Amount Of State Severance Tax Reimbursement Authorized By Congress And Are Thereby Prevented From Realizing The Full Amount Of The Incentive Ceiling Prices (Exclusive Of Severance Tax) Applicable to Natural Gas Produced And Sold From Such Lands; And

(b) The Plain Meaning Of The NGPA Requires That Severance Tax Reimbursement Lawfully Collected By The Lessee Under Authority Of NGPA Section 110(a)(1) Not Be Claimed As Royalty By A Severance Tax Exempt Royalty Owner.

In this case, Interior required that the amount of severance tax borne by and reimbursed to the lessee be included in calculating the value of the severance tax exempt royalty share of natural gas produced and sold from federal and restricted Indian lands. The result of Interior's decision is to prevent the lessee from retaining the full amount of severance tax reimbursement received

with respect to its share of production, thereby preventing the lessee from realizing the full amount of the applicable NGPA ceiling price, while permitting the federal or Indian lessor to receive more than the applicable NGPA ceiling price as royalty on the tax exempt royalty share of production. Interior's decision has other adverse consequences, including the reduction of the practical incentive value of the NGPA ceiling prices and the appropriation of amounts paid by consumers as tax reimbursement for the use and unjust enrichment of tax exempt royalty owners.

This case presents important issues involving interpretation of federal statutes and regulations and the implementation of two federal regulatory schemes which, by reason of Interior's decision in this case, are in irreconcilable conflict.

The NGPA Background

The right to receive and retain reimbursement for severance taxes imposed on production was an essential element of the statutory ceiling price concept under the NGPA. Congress established a system of uniform ceiling prices at levels intended by Congress to be "exclusive of State severance taxes borne by the seller."[12] Unless a lessee is permitted to recover and retain the full amount of any severance tax imposed, he is prevented from realizing, after payment of the severance tax, the full amount of the applicable ceiling price.[13]

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[12]Joint Explanatory Statement of the Committee on Conference, 7 U.S. Code Cong. & Admin. News, 95th Cong. 2nd Sess., 1978, at 9007.

[13]On this point lessees and private royalty owners stand in the same position because as a general rule the law requires a royalty interest in gas to bear its proportionate share of any severance tax levied on production. 3 Williams, Oil and Gas Law §645.2 (1981); 84 C.J.S. *Taxation* §68e (1954). When the tax is reimbursed the same proportionate share of the reimbursement inures to the benefit of the royalty owner. To the extent that the royalty interest is *exempt* or legally immune from the severance tax, however, there is no tax paid

In *Public Service Commission v. Mid-Louisiana Gas Co.*,[14] this Court recently examined the history of federal regulation of natural gas sales and the economic circumstances which led to enactment of the NGPA. After a thorough review, the Court observed that the statute set up "a precise schedule of price ceilings ... intended to provide investors with adequate incentives to develop new sources of supply."[15] "In addition," the Court stated, "the costs of providing these production incentives are plainly to be shouldered by downstream consumers ..."[16]

When it enacted the NGPA, Congress recognized the differences among severance tax rates imposed by various states, local authorities, and Indian tribes.[17] In order to ensure an effectively uniform incentive price structure for gas produced in the various tax jurisdictions,

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and there can be no tax reimbursement. In the instant case, the federal and restricted Indian royalty share of natural gas production is exempt from the Oklahoma severance tax. *See* 68 Okla. Stat. §§1008, 1106.

[14]103 S.Ct. 3024 (1983).

[15]*Id.* at 3033.

[16]*Id.* at 3034.

[17]When Congress had the NGPA under deliberation, the important question of the extent of the power of Indian tribes to impose severance taxes on oil and gas removed from their reservations was under review in the federal courts. While Congress chose not to prejudge the outcome of those pending cases, it provided that any severance taxes "which may be imposed by an Indian tribe are to be treated in the same manner as State imposed severance taxes." Joint Explanatory Statement, *supra* note 12, at 9007. In *Merrion v. Jicarilla Apache Tribe*, 455 U.S. 130 (1982), this Court sustained the authority of Indian tribes to impose such taxes. In its opinion in that case, the Court took notice of NGPA Section 110, stating that "Congress has included taxes imposed by an Indian tribe in its definition of *costs that may be recovered* under federal energy pricing regulations." *Id.* at 151-52 (emphasis added). The royalty calculation methodology which Interior has adopted in this case operates to deny the producer recovery of a portion of such costs.

Congress set the NGPA ceiling prices at levels intended to be exclusive of severance taxes and permitted the ultimate incidence of the severance taxes to be shifted to the consumer. Thus, where tax reimbursement is paid in excess of the maximum lawful price, the cost of the tax reimbursement is passed through to the consumer by the pipeline purchaser along with the remainder of the gas purchase costs.[18]

The Results of Interior's Decision

Where a portion of tax reimbursement costs ultimately borne by the consumer is appropriated by a tax exempt royalty owner, it is clear that the statutory purpose in allowing the ceiling price to be exceeded under Section 110 is thwarted. The tax exempt royalty owner gets a windfall in excess of the ceiling price. The producer is prevented from realizing the full amount of the ceiling price, and its value as an incentive is to that extent diminished. Ultimately, the consumer pays in excess of the ceiling price, not for the purpose of keeping the taxpaying lessee whole and preserving the incentive value of the uniform NGPA ceiling prices (exclusive of severance tax) as envisioned by Congress, but instead for the purpose of enriching the tax exempt royalty owner. This result is "by necessary implication"[19] in conflict with the ceiling price and tax reimbursement scheme Congress established under NGPA.

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[18]Where gas is sold for resale in interstate commerce, the NGPA specifically so provides. NGPA Section 110(a)(1), 15 U.S.C. §3320(a)(1), (reimbursement of severance taxes borne by the seller "shall not be considered to exceed the maximum lawful price applicable..."); NGPA Section 601(b)(1)(A), 15 U.S.C. §3431(b)(1)(A), ("any amount paid in any first sale of natural gas shall be deemed to be just and reasonable if — (i) such amount does not exceed the applicable maximum lawful price..."); NGPA Section 601(c)(2), 15 U.S.C. §3431(c)(2), (interstate pipelines may not be denied recovery of amounts paid for the purchase of natural gas if such amount is "deemed to be just and reasonable" under Section 601(b)).

[19]*Fed. Election Comm'n v. Democratic Senatorial Campaign Comm.*, 454 U.S. 27, 36 (1981).

In *Commonwealth Edison Co. v. Montana*,[20] this Court sustained a state mineral severance tax levy of up to 30% of the sales price of the mineral (coal). In disposing of the Commerce Clause claims made there, and the collateral argument that royalty to the federal government might be *reduced* as a result of the Montana tax, the Court noted the following:

> "20. Indeed, appellants alleged in their complaints that the contracts between appellant coal producers and appellant utility companies *require* the utility companies to reimburse the coal producers for their severance tax payments, and that the ultimate incidence of the tax primarily falls on the utilities' out-of-state customers ... Presumably, with regard to these contracts, the Federal Government's receipts will be unaffected by the Montana tax."[21]

As the Court noted, "presumably" the government royalty would be "unaffected" by the tax and tax reimbursement arrangement. But in the instant case, where Congress foresaw and provided for precisely the same type of tax reimbursement arrangement discussed in *Commonwealth Edison* as an augment to its NGPA wellhead ceiling price structure, the effect of Interior's royalty valuation methodology is to increase government royalty as a result of tax reimbursement to the non-exempt lessee. Astoundingly, as the level of tax and tax reimbursement increases the government royalty increases —even though the government royalty interest is tax exempt and should, as in *Commonwealth Edison*, be "unaffected" by the tax and tax reimbursement. Likewise, as tax reimbursement funds are used to increase the "value" of the government royalty interest, the gas producer's ceiling price is effectively reduced, cent-for-cent. Interior's decision to bring economic gain to tax exempt

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[20]453 U.S. 609 (1981).

[21]*Id.* at 630, n.20.

royalty interests as a result of such severance tax reimbursement should be set aside by this Court.

As demonstrated above, the result of implementing Interior's decision in this case would be "contrary to the history, structure, and basic philosophy of the NGPA."[22] Implementation of Interior's decision would "frustrate the policy Congress sought to implement" in establishing incentive ceiling prices under the NGPA.[23] Interior should be held without discretion to interpret and apply its regulations governing royalties on natural gas produced from federal and restricted Indian lands in such a manner. Interior also should be held without authority to claim, as royalty on natural gas produced from federal and restricted Indian lands, a portion of the amount paid by the purchaser of such natural gas as a reimbursement of state severance taxes levied on the lessee's share of production.

II. The Court Of Appeals Incorrectly Accorded Great Deference To The Decision Of Interior In This Case, In Conflict With Applicable Decisions Of This Court And Other Courts Of Appeals.

The court of appeals acknowledged at the outset "that the matter before us is a question of law." (App. A-3). The court of appeals nevertheless determined that "[d]eference is due the construction of a statute or a regulation of an administrative agency," noting that "[t]he standard of review for an administrative agency's interpretation of its own regulation is that of a plainly erroneous or inconsistent standard." (App. A-4). Contrary to the court of appeals' conclusion, however, this case cannot properly be decided under a standard of review applicable to an administrative agency's interpretation of its own regulation.[24]

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[22] *Pub. Serv. Comm'n v. Mid-Louisiana Gas Co.*, 103 S.Ct. at 3037.

[23] *Id.*, quoting from *Fed. Election Comm'n v. Democratic Senatorial Campaign Comm., supra.*

[24] The cases relied on by the court of appeals in adopting its standard of

A. Interior Is Not Entitled To Deference In This Case Because Its Decision Is Not Reasonable In Light Of The Ceiling Price And Tax Reimbursement Provisions Of The NGPA.

In *Process Gas Consumers Group v. United States Department of Agriculture*,[25] the United States Court of Appeals for the District of Columbia Circuit stated:

> "The extent to which courts should defer to agency interpretations of law is ultimately 'a function of Congress' intent on the subject as revealed in the particular statutory scheme at issue.' "[26]

The dispute in this case has arisen chiefly under the statutory scheme of the NGPA. Since Interior's decision clearly causes results contrary to Congress' intent under that scheme, it should have been accorded no deference by the court of appeals.

The district court below determined that Interior's interpretation and application of its "Wheless doctrine" in the instant case conflicted with Congressional gas pricing policy under the NGPA, and was "designed to place a value upon its [tax exempt royalty] share of the production that is in excess of the maximum lawful price... contrary to the expressed provisions of the law." (App. E-7). The court of appeals acknowledged the

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review, *Udall v. Tallman*, 380 U.S. 1,(1965); *Davon Corp. v. FERC*, 662 F.2d 698 (10th Cir. 1981); *Morrison and Morrison, Inc. v. Secretary of Labor*, 626 F.2d 771 (10th Cir. 1981), each involved a dispute over an administrative agency's interpretation of its own regulation, not of the conflict of such interpretation with a separate statute under which the agency had no administrative authority. The same is true of the cases on which the cited cases rely. *See U.S. v. Larionoff*, 431 U.S. 864 (1977); *INS v. Stanisic*, 395 U.S. 62 (1969); *Belco Petroleum Co. v. FERC*, 589 F.2d 680 (D.C. Cir. 1978).

[25]694 F.2d 778 (D.C. Cir. 1982) (en banc), *cert. denied*, 103 S.Ct. 1874 (1983).

[26]*Id.* at 791.

change in gas pricing policy under NGPA but failed to recognize that continued application of the "Wheless doctrine" would create such an unreasonable result under NGPA Section 110. The court of appeals was under the false impression that "*Wheless* only effects [sic] the amount of royalties a producer must pay if a tax reimbursement scheme is present," and that "under *Wheless*, a seller can still receive up to the maximum NGPA." (App. A-8). On the contrary, application of the "Wheless doctrine" denies the lessee the opportunity to recover the NGPA maximum lawful price and permits the tax exempt royalty owner to recover more than the maximum lawful price for its royalty share of the gas. A portion of the costs ultimately borne by consumers for severance tax reimbursement in excess of the maximum lawful price goes to the tax exempt royalty owner, not to the person who bears the severance tax as Congress intended. Thus, whatever its merits in the two-tiered market structure which existed prior to passage of the NGPA,[27] it is clear that application of the "Wheless doctrine" under the uniform ceiling price and tax reimbursement scheme of the NGPA is unreasonable and contrary to law.[28]

In *Federal Election Commission v. Democratic Senatorial Campaign Committee*,[29] this Court observed that a discussion and conclusion by a court of appeals concerning the amount of deference due a decision of an administrative agency would be "pointless" if it were determined that the agency action "violated the plain language of the Act as well as the statutory purposes revealed by the legislative history."[30] Accordingly, no deference should have been accorded to the decision of Interior in this case, since it

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[27] *See, Pub. Serv. Comm'n v. Mid-Louisiana Gas Co.*, 103 S.Ct. 3024 (1983).

[28] As succinctly expressed by the Chief Judge, dissenting, below: "Interior is . . . trying to hold on to a position which cannot be reconciled with the NGPA. The consequence is that one agency of Government is seeking to bring about a result contrary to that of another." (App. A-12).

[29] 454 U.S. 27 (1981).

[30] *Id.* at 31.

cannot be concluded that application of the "Wheless doctrine" is consistent with "a reasonable interpretation of the relevant [statutory] provisions."[31]

B. Interior Is Not Entitled To Deference In This Case Because It Does Not Have "Primary Responsibility" For Administering The Federal Regulatory Scheme Under The NGPA.

NGPA Section 501(a)[32] is clear: "Except where expressly provided otherwise, the [Federal Energy Regulatory] Commission shall administer this Act." No exception appears in the Act to grant Interior authority to administer the ceiling price or tax reimbursement provisions of the Act or to require that royalty on gas produced from federal or restricted Indian lands be calculated and paid in a manner which cannot be reconciled with such provisions. Indeed, the Act expressly *subjects* Interior to its requirements. For example, if Interior makes a "first sale" of natural gas, it may not charge more than the applicable NGPA maximum lawful price.[33]

In the instant case, Interior, acting as lessor and royalty owner, has reserved the amount or "value" of a specified percentage of any gas produced and sold from lands covered by its oil and gas leases. Interior has required that such "value" be calculated by adding to the maximum lawful price the amount of severance tax

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[31] *Am. Paper Institute Inc. v. Am. Electric Power Serv. Corp.*, 103 S.Ct. 1921, 1933 (1983).

[32] 15 U.S.C. §3411(a).

[33] NGPA Section 504(a)(1), 15 U.S.C. §3414(a)(1), provides as follows: "(a) General Rule. — It shall be unlawful for any person - (1) to sell natural gas at a first sale price in excess of any applicable maximum lawful price under this Act ..."

NGPA Section 2(26), 15 U.S.C. §3301(26), provides as follows: "(26) Person. — The term 'person' includes the United States, any State, and any political subdivision, agency, or instrumentality of the foregoing."

lawfully paid and reimbursed on the *remainder* of the gas stream — the portion in which it has *no interest*. In these circumstances, the decision of Interior should be distinguished from the type of agency action "to which deference should be presumptively afforded."[34] Interior must be deemed to lack any "inherently bipartisan" qualities which might militate in favor of according some deference to its decision.[35] Nor does Interior have "primary and substantial responsibility for administering and enforcing" the NGPA, under which the dispute in this case has arisen.[36] Indeed, as pointed out above, Interior is itself *subject to* the provisions of the NGPA. Interior has no rulemaking or adjudicative powers under the NGPA[37] and is not authorized to formulate policy with respect to the administration of the NGPA. All of these functions are vested in the Federal Energy Regulatory Commission. "The underlying logic for deference . . . largely depends on the agency having 'primary responsibility' for administering a statute, . . ."[38] That "underlying logic" is not present in this case.

Under the standards of reasonableness, consistency with the statutory scheme at issue, and primary responsibility enunciated by this Court and followed and elaborated by the Court of Appeals for the District of Columbia Circuit, no deference should have been accorded the decision of Interior in this case. The decision of the Court of Appeals for the Tenth Circuit is thus in conflict on this important federal question and should be reviewed and set aside by this Court.

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[34] *Fed. Election Comm'n v. Democratic Senatorial Campaign Comm.*, 454 U.S. at 37.

[35] *Id.*

[36] *Id.*

[37] Interior does have the authority to make certain well category determinations under the NGPA, subject to review by the Federal Energy Regulatory Commission. *See* NGPA Section 503, 15 U.S.C. §3413, and 18 C.F.R. Parts 274, 275.

[38] *Process Gas Consumers Group v. U.S. Dept. of Agriculture*, 694 F.2d at 792.

III. The Decision Of Interior Is Arbitrary, Capricious And Unreasonable Because It Prescribes A Method Of Valuing Gas For Royalty Purposes Which Produces Different Results Depending On The Identity Of The Seller, The Tax Jurisdiction In Which The Lands Are Situated And The Percentage Of Federal Or Restricted Indian Lands Included Within The Producing Unit.

H&B sells all of the gas produced from or attributable to the federal and restricted Indian lands covered by its leases at the maximum lawful price for which such gas may be sold under the NGPA. The purchaser of such gas remits to the Oklahoma Tax Commission the amount of state severance tax due on the non-tax exempt portion of such production and pays to H&B the NGPA ceiling price applicable to the gas sold. H&B in turn pays royalty to its lessors at the NGPA ceiling price received from the purchaser. In order to demonstrate the arbitrary and capricious nature of the royalty valuation method prescribed by Interior, H&B would point out the effect on such valuation method of the following factors.

The Identity Of The Seller

If Interior were to take "in kind"[39] the royalty share of gas produced from the federal and restricted Indian lands covered by H&B's leases, as the lessor is permitted to do under the provisions of the leases and the applicable regulations, and then proceed to sell such royalty gas for the highest and best price lawfully obtainable, Interior would be prohibited by the terms of the NGPA from receiving any amount for the sale of such gas in excess of

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[39]That is, take delivery of the royalty share of production on the leased premises.

the amount paid by H&B as royalty under the leases.[40] Inasmuch as no state severance tax is levied on the federal and Indian royalty share of production, Interior could not lawfully receive from its purchaser any amount in excess of the NGPA ceiling price applicable to the gas sold.[41]

In the decision below, Interior conceded that under its method of determining "value" for royalty purposes, the lessors under H&B's leases are entitled to receive more for the royalty share of production when H&B is selling the gas than lawfully could be received by the lessors if the royalty share of production were taken in kind and sold. (App. D-9). Accordingly, Interior has acknowledged that under its method of determining gas royalties due under H&B's leases, the identity of the seller (*i.e.*, lessor or lessee) has a direct and significant effect on the "value" of the gas. H&B contends that calculating the value of a commodity based upon the identity of the seller is arbitrary and unreasonable by any definition.

The Tax Jurisdiction In Which The Lands Are Situated

Interior's method for determining the "value," for royalty purposes, of natural gas produced from federal and restricted Indian lands produces different results depending upon the rate of severance tax imposed by the various states, local authorities and Indian tribes. For example, where two virtually identical gas producing units are separated only by a state boundary line, under Interior's method the "value" for royalty purposes of

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[40]The maximum lawful prices prescribed by the NGPA are applicable to sales of gas by the federal government and any agency or instrumentality thereof. *See* note 33, *supra.*

[41]NGPA Section 110(a), 15 U.S.C. §3320(a), permits reimbursement of state severance taxes over and above the NGPA ceiling price only to the extent such severance taxes are "borne by the seller."

natural gas produced from the unit lying within the state having the higher severance tax rate is greater than the "value" of the gas produced from the adjacent unit lying within the state having the lower rate of tax. The only difference in the "value" so determined by Interior is the amount of the severance tax levied on the non-tax exempt portion of production, that is, the greater royalty "value" simply is a function of the severance tax rate. This result not only evidences agency action which is arbitrary and capricious, but also is contrary to the express intent of the NGPA in providing incentive price uniformity nationwide without regard to the varying percentages of severance taxes imposed by the various tax jurisdictions.

The Percentage Of Federal Or Restricted Indian Lands In The Unit

Under the royalty valuation method prescribed by Interior, the lessee is required to take into account the amount of tax reimbursement paid with respect to all of the non-tax exempt interests in production from the unit. For example, if a producing unit were comprised entirely of federal or restricted Indian lands, only the lessee's working interest share of production would be subject to the levy of state severance taxes. Therefore, in "valuing" the royalty share of production, Interior would take into account the amount of tax reimbursement paid with respect to the lessee's working interest share of production. If, on the other hand, federal or restricted Indian lands were to comprise only 10% of the unit and private lands the remaining 90%, then a much larger percentage of total unit production would be subject to the levy of state severance taxes (*i.e.*, all of the working interest share and 90% of the royalty share of production). Under the method prescribed by Interior, the "value" of the federal or Indian royalty share of gas produced and sold from the unit comprised of 10% federal or restricted Indian lands would be substantially greater than the "value" of the royalty share of gas produced from the unit comprised entirely of

federal or restricted Indian lands. Accordingly, under Interior's method the "value" of the federal and restricted Indian royalty share of production bears an inverse relation to the percentage of federal and restricted Indian lands included within the producing unit.[42]

In its decision below, the IBLA acknowledged that under Interior's method the "value" of gas for royalty purposes varies in proportion to the percentage of federal or restricted Indian lands included within each producing unit. (App. D-10). No reasonable explanation of such an anomalous result was offered by Interior.

In view of the foregoing examples, it is readily apparent that the method prescribed by Interior for valuing the royalty share of production under H&B's leases of federal and restricted Indian lands clearly is arbitrary, capricious and unreasonable, and therefore must be set aside.

IV. This Is A Case Of Substantial Importance; The Outcome Of This Case Will Determine The Gas Royalty Payment Obligations Of Every Lessee Of Onshore Federal And Restricted Indian Lands Selling Gas Under A Contract Providing For Reimbursement Of State Severance Taxes In Addition To The NGPA Ceiling Price.

This case involves the proper construction of a major federal statute, the NGPA, and therefore is deserving of consideration and decision by this Court.[43] It is an important case of first impression with respect to the issues presented herein.

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[42]The value of the federal or Indian royalty share of production also would be different in two identical units where the federal or Indian leases in the two units contain different royalty percentages.

[43]This Court has granted certiorari in prior cases involving issues requiring the construction of a major federal statute. *See, e.g., U.S. v. Donovan*, 429 U.S. 413 (1977), and *U.S. v. Ruzicka*, 329 U.S. 287 (1946).

Although this is the first case on this issue to be litigated through the circuit court level, the natural gas exploration and production industry has expressed substantial interest in the outcome of this case. If this Court refuses to grant the writ requested herein, it is anticipated that other producers will initiate similar cases against Interior in other circuits in an effort to obtain a more favorable result. Accordingly, by granting the requested writ and deciding this case, this Court could settle the issue in a manner which would preclude litigation of similar claims in other circuits.[44]

The importance of the Court's disposition of the issues raised herein is not limited to the parties involved. The outcome of this case will determine the gas royalty payment obligations of all lessees of onshore federal and restricted Indian lands who produce and sell natural gas under a contract providing for the collection of the NGPA ceiling price plus reimbursement of state severance taxes. H&B believes that a substantial percentage of all lessees of federal and restricted Indian lands sell gas under contracts providing for collection of the NGPA ceiling price plus reimbursement of such taxes. In like manner, this case will have a direct and significant impact on the royalty revenues received by the federal government and Indian lessors whose lands are subject to the supervisory authority of Interior for gas produced and sold under circumstances similar to that described herein. Accordingly, this is a case of substantial importance to the utilization of public and trust lands.[45]

For the reasons hereinabove set forth, H&B believes that this is a case of substantial importance, not just to H&B and the lessors under the specific leases involved, but also to other lessees and lessors similarly situated, to

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[44]In *U.S. v. Powell*, 330 U.S. 238 (1947), this Court granted certiorari "because of the importance of determining the controlling principle for settlement of the many claims of this character against the Government." *Id.* at 240.

[45]*See U.S. v. Coleman*, 390 U.S. 599, 601 (1968).

consumers of natural gas, and to the utilization of public and trust lands under the supervisory jurisdiction of Interior. Accordingly, H&B would urge the Court to grant the writ requested herein and to decide the issues presented in this case.

CONCLUSION

WHEREFORE, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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May 3, 1984

APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS

TENTH CIRCUIT

Filed
United States Court of Appeals
Tenth Circuit
Dec 28 1983
Howard K. Phillips
Clerk

HOOVER & BRACKEN ENERGIES, INC.,)
Plaintiff-Appellee)
)
v.)
)
UNITED STATES DEPARTMENT)
OF THE INTERIOR, *et al*)
Defendants-Appellants)

Appeal from the United States District Court
For the Western District of Oklahoma
(D. C. No. CIV-81-461-T)

C. David Stinson, McAfee & Taft, Oklahoma City, Oklahoma (Gary W. Catron, McAfee & Taft, Oklahoma City, Oklahoma, with him on the brief), for Plaintiff-Appellee.

Blake Andrew Watson, Department of Justice, Washington, D.C., (Carol E. Dinkins, Assistant Attorney General, Washington, D.C.; John E. Green, Acting United States Attorney, Oklahoma City, Oklahoma; Roger Stuart, Assistant United States Attorney, Oklahoma City, Oklahoma; Edward J. Shawaker and Laura Frossard, Attorneys, Department of Justice, Washington, D.C., on the brief), for Defendant-Appellant Department of the Interior.

[APPENDIX]

Robert A. Hasty, Jr., Houston, Texas (Thomas G. Johnson, Houston, Texas, with him on the brief), for Amicus Curiae Shell Oil Company.

Before SETH, Chief Judge, McWILLIAMS and DOYLE, Circuit Judges.

DOYLE, Circuit Judge

This is an appeal from a district court order which overruled a decision of the Interior Board of Land Appeals (IBLA). The matter presented is that of royalties which are allegedly owed to the government for the production of natural gas on federal and Indian lands. The appellee herein, also the plaintiff, is a producer of oil and gas and holds interests in several oil and gas leases of federal and Indian lands. These have been communitized with private lands. Leases which were held by Hoover & Bracken require that royalties be paid on a basis of the percentage of the value of the gas produced.

The underlying question is whether these royalties are to be measured based upon what is called the value of the gas produced.

The United States contends that this value includes the severance tax which Oklahoma levies on the land. This amounts to seven percent of the gross value of the production of the natural gas.[1,2] There is also a .085 percent excise tax on the gross value.[3] Both taxes are paid by the purchaser. This is in accordance with the statute. The production from federal and non-Indian lands is exempt from *payment* of the state severance tax under Oklahoma Statute Title 68, §§1008, 1106 (Supp. 1981).

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[1]The leases for the non-Indian federal lands provide that a royalty of 12½% on production shall be computed according to the provisions of 30 C.F.R. 221.47. The leases of the Indian lands provide for a royalty of 16⅔% of the value of the natural gas produced.

[2]Okla. Stat. Tit. 68, §1001 (b) (Supp. 1981).

[3]Okla. Stat. Tit. 68, §1102 (Supp. 1981).

Hoover & Bracken entered into contracts for the sale of gas produced on the communitized lands at the maximum price allowed by the Natural Gas Policy Act of 1978, 15 U.S.C. § 3301, *et seq.* (NGPA). These contracts provide that the purchaser will pay any state severance taxes. This is commonly known as a tax reimbursement.

Hoover & Bracken has been paying royalties to the government on the federal and Indian lands, using a maximum NGPA price as the value of production. The government, however, felt that the value of production used to compute royalties should be higher — the maximum NGPA price for the gas received by Hoover & Bracken plus the amount of severance tax paid by the purchasers on the communitized lands, i.e., the tax reimbursement.

In 1979 the United States Geological Survey notified Hoover & Bracken that the royalties paid were insufficient as they were calculated only from a percentage of the NGPA price and failed to include the amount of tax reimbursements. Hoover & Bracken appealed this decision to the Acting Director of the USGS, and the Acting Deputy Commissioner of the Bureau of Indian Affairs. Its appeal was denied. Hoover & Bracken then appealed it to the Interior Board of Land Appeals. That body upheld the determination that the amount of tax reimbursements be included in the value of production for the purpose of computing royalty payments. Then Hoover & Bracken brought an action in the Western District of Oklahoma, and was successful in obtaining a reversal of the IBLA decision. In other words, the district court ruled for Hoover & Bracken on a motion for summary judgment.

It is apparent that the matter before us is a question of law. *See First National Bank in Sioux Falls v. National Bank of South Dakota*, 667 F.2d 708 (8th Cir. 1981). It is also a policy problem which asks whether the operator shall obtain added profits at the expense of the United States. Although the construction of the statutes and

regulations before us is for the courts, it does not follow that the agency interpretation is to be disregarded by a reviewing court. Deference is due the construction of a statute or a regulation of an administrative agency. *Udall v. Tallman*, 380 U.S. 1 (1965). Indeed, when an agency is interpreting its own regulations, the courts have given added deference to the agency's construction. The standard of review for an administrative agency's interpretation of its own regulation is that of a plainly erroneous or inconsistent standard. *Davon Corp. v. Federal Energy Regulatory Commission*, 662 F.2d 698 (10th Cir. 1981), and *Morrison and Morrison, Inc. v. Secretary of Labor*, 626 F.2d 771 (10th Cir. 1981). We consider the decisions below upon the basis mentioned.

First, the IBLA ruling was that the value of production for the purpose of determining the royalties owed on the federal and Indian lands included the price received for the gas by the gas producer plus the amount of state severance tax paid by the purchaser. IBLA relied on its prior decision in *Wheless Drilling Co.*, 13 IBLA 21, 80 I.D. 599 (1973). The facts and issues in *Wheless* are pretty much the same as those present here. Federal and private lands had there been communitized. State severance taxes were paid only on the non-federal portion. The issue was the amount of royalties owed to the government, as here. The gas producer in *Wheless* argued that the figure to be used to calculate royalties was the field price set by the Federal Power Commission pursuant to the Natural Gas Act, 15 U.S.C. § 717, *et seq.* (1970). The government, however, maintained that the figure to be used was the field price plus the amount of tax reimbursement. The IBLA so ruled. It said:

> It seems obvious to us that the buyer is thus paying to the seller an amount greater than the established field price for the natural gas it purchases from the # 1 T. L. James well. It follows, therefore, that it is reasonable to compute the Federal royalty of the natural gas taken from this well on a unit value consisting of the

> field price established by the FPC plus the amount of the severance tax reimbursed by the buyer.

Wheless, 13 IBLA 21, 80 I.D. at 603.
IBLA noted that absent any reimbursements for state severance taxes on production on communitized lands, the FPC ceiling price would be the proper figure to use to compute royalties.

The IBLA, as in *Wheless*, interpreted 30 C.F.R. 221.47.[4] The IBLA reiterated its interpretation of the term "gross proceeds" as it is contained in 30 C.F.R. § 221.47 as "the established price for the natural gas plus any additional sums paid by the purchaser of the gas to the unit operator as consideration for the purchase of gas from the unit of which the federal lease is a part." The IBLA also found that notwithstanding its decision in *Wheless*, it would come to the same conclusion here. The *Wheless* case focused on the definition of gross proceeds in 30 C.F.R. § 221.47. In the case at bar the IBLA proceeded to analyze the question in terms of the definition of "reasonable value" in the same regulation. It held that the value of

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[4]The regulation just cited provides as follows:

> The value of production, for the purpose of computing royalty shall be the estimated reasonable value of the product as determined by the supervisor, due consideration being given to the highest price paid for a part or for a majority of the production of like quality in the same field, to the price received by the lessee, to posted prices and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

production was not necessarily synonomous with gross proceeds, which is the amount the producer received for the gas. Indeed, there are suggestions in some of the opinions that value is not necessarily the same as price. *Domatti v. Exxon Corporation*, 494 F.Supp. 306, 314 (W.D. La. 1980), and *Agurs v. Amoco Production Co.*, 480 F.Supp. 737 (W.D. La. 1979) (existence of a federal regulation fixing a maximum rate is absolutely no obstacle to the fixing of a higher rate as the market value of gas for the purpose of computing royalties).

The plaintiff-appellee appears to rely on *Bowers v. Phillips Petroleum*, 692 F.2d 1015 (5th Cir. 1982) as being controlling on the question as to whether the value of production may exceed the maximum ceiling price. On the facts presented in that case the value of production could not exceed the NGPA ceiling price. This case is different on its facts and does not address the question of state severance taxes or the specific statutory treatment of state severance tax in relation to the set maximum prices.

It is important to note that the IBLA stated that the clear language of the regulation specified that all relevant matters shown be considered in determining the estimated reasonable value. The value of production is based on the estimated reasonable value. One relevant factor was § 3320(a) of the NGPA which provides:

> (a) Allowance for State severance taxes and certain production-related costs. — Except as provided in subsection (b) of this section, a price for the first sale of natural gas shall not be considered to exceed the maximum lawful price applicable to the first sale of such natural gas under this part if such first sale price exceeds the maximum lawful price to the extent necessary to recover
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> (1) State severance taxes attributable to the production of such natural gas and borne by the seller, but only to the extent the amount of such taxes does not exceed the limitation of subsection (b) * * *

The IBLA thought that it was relevant to consider the reimbursement of the state severance tax. Although this section of the NGPA specifies that the exception applies when state severance taxes are borne by the seller and Oklahoma requires them to be paid by the purchaser, the IBLA reasoned that in this case, the economic result was the same. The IBLA noted that Hoover & Bracken received the ceiling amount because the actual price to the purchaser was the ceiling amount plus the amount of taxes. Accordingly, the IBLA found that the reasonable value exceeded the gross proceeds.

The IBLA also cited a policy reason. It considered to whom the benefit of the federal government's sovereign immunity should flow:

> The fact that the United States cannot be assessed state insurance tax does not depreciate the *value* of the gas to it. Immunity from state taxation is a function of the Federal Government's sovereignty, which prevents the state from assessing a severance tax. This benefit flows to the Government, not the lessor.

Hoover & Bracken Energies, Inc., 52 IBLA 27, 37.

The district court ruled in favor of Hoover & Bracken. Thus, it is reversed. The district court was of the opinion that *Wheless* was not controlling based on the post-*Wheless* changes in the federal regulations of the gas market. At the time *Wheless* was decided in 1973, there were two gas markets, the regulated interstate market, and the unregulated intrastate market. The NGPA of 1978, however, sets uniform ceiling prices nationwide. *Wheless* was considered to be inapplicable based on this change. The district court failed to explain why it felt that this change in the federal regulation of the gas market led to its conclusion that *Wheless* was inapplicable. The United States Supreme Court noted that the purpose of the NGPA was to "alleviate the adverse economic effects of the desparate treatment of intrastate and interstate

natural gas sales." *Maryland v. Louisiana*, 451 U.S. 725, 747 at n. 22 (1981). The district court did take note of the fact that under the NGPA the seller is entitled to receive up to the maximum ceiling price regardless of whether a state imposes severance taxes on the seller or the buyer. *Wheless* does not appear to effect the above quoted purpose of the NGPA. Furthermore, under *Wheless*, a seller still can receive up to the maximum NGPA; *Wheless* only effects the amount of royalties a producer must pay if a tax reimbursement scheme is present.

There is no reason why the enactment of the NGPA should effect the force of the *Wheless* decision. While *Wheless* does not necessarily control this situation, it is, nevertheless, entitled to deference. This is particularly so in view of its basic fairness and its having been in effect for ten years, and has presumably been relied on by gas producers and lessors in their private law making. This established system for computing royalties for communitized lands that include federal acreage should not be overruled lightly. The reason given by the district court does not justify reversal of a well-reasoned opinion of an administrative agency. Absent a convincing reason to decide otherwise, this case should follow *Wheless*.

As we have indicated, the district court, after having commented on *Wheless*, then reversed the IBLA based on the court's interpretation of § 3320(a) of the NGPA. As set out above this section of the statute allows the ceiling price to be exceeded to the extent necessary to recover state severance taxes attributable to the production of such gas when the taxes are borne by the other. We see no basis for abandoning *Wheless* after ten years.

The district court considers it unlawful to value the production above the ceiling price when the gas attributable to the federal and Indian lands was not subject to any state severance tax. This fails to consider the dispositive fact that the lands at issue are communitized. It is readily apparent that communitized land cannot be readily changed from being communitized for one purpose and

then segregated because it results in lower royalty payments. To adopt the interpretation of the district court it would have this effect.[5]

The general rule for royalty payments when a communitization agreement is in effect is that the "lessors of land participating in a unit agreement share in royalties from the *unit* based upon the number of acres committed to them by the unit." *Anadarko Production Co. v. Taylor*, 535 F. Supp. 103, 110 (D.Ks. 1982) (emphasis added), citing Cook, *Rights and Remedies of the Lessor and Royalty Owner Under a Unit Agreement*, Third Annual Institute on Oil and Gas Law and Taxation, p. 111 (1952).

To prohibit the value of production in royalty calculations from including tax reimbursements because no state severance tax is attributable to the federal and Indian lands violates the general rule. Furthermore, it is readily apparent that the lands cannot at the same time be communitized and segregated. Appellee is not entitled to have it both ways. Presumably it has received benefits from the communitization agreements. It cannot now, merely because it would be to its economic advantage, treat the lands as if they were not communitized. The IBLA, in *Wheless*, rejected the gas producers' attempt to

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[5]The parties here agree to the statement of facts as follows:

These federal Indian lands have been communitized with privately-owned lands. Under these communitization agreements all land included within one drilling and spacing unit, as established by the Oklahoma Corporation Commission (in Western Oklahoma such a unit is usually 640 acres) is developed as though the land were all under one lease, although in fact the land may be owned by many different lessors and leased to many different lessees. Communitization allows production from one well within the unit to constitute production from each lease within the unit, thereby preserving each lease. Costs are borne by each lessee according to what percentage of the total acreage in the unit he or she has leased and production from the unit is allocated to each lessee and royalty owner in accordance with each lease's term. Brief for Appellants at p. 4. This statement was agreed to by Appellees, in Brief for Appellees at p. 2.

segregate communitized lands when the time came to compute royalties. Undoubtedly this is the correct position and the court ought not to allow communitized lands to be segregated for the mere purpose of computing royalties. To do so also deprives the federal government of funds to which it is entitled. And also, it effects the Indians.

In the final analysis, the problem boils down to the following. First, the value of production is basic for payment of royalties. Second, the gas is sold to a buyer. Third, the maximum price allowed by law includes the severance tax. Oklahoma has its tax, but federal lands are exempt from it. Fourth, the buyer pays it. The seller has received the contract price, plus severance tax. The gas producer says, in effect, "we only owe royalties on the contract price received. Our lease says value of production. What is the value of production? Is it contract price, or contract price, plus severance." The latter is the value of production for payment of royalties.

One more thing: It is apparent that *Wheless* is a persuasive authority. While it does not control this court's decision, the decision so made has been in effect for ten years and has been utilized by lessees and lessors for the past ten years. The enactment of the NGPA does not effect the soundness of the reasoning present in *Wheless*.

Accordingly, the case should be decided in accord with *Wheless*, unless there is some good reason to depart from it. The construction given to § 3320(a) of the NGPA by the district court would negate the communitization agreement, and would cause confusion in this body of law. We are not moved to abandon *Wheless* under the circumstances presented.

For the reasons stated, then, the judgment of the district court must be reversed and at the same time, the judgment of the Department must be affirmed.

Accordingly, the judgment of the district court is reversed and the cause is remanded for further proceedings.

82-1074 - Hoover & Bracken Energies, Inc. v. United States Department of the Interior, et al.

SETH, Chief Judge, dissenting:

I must dissent from the majority opinion because, in my view, it permits the Department of Interior to adopt practices contrary to the Natural Gas Policy Act (15 U.S.C. § 3301). I would affirm the judgment of the trial court.

Classifications and ceiling prices under the NGPA were constructed by Congress to encourage production of natural gas. It adopted the incentive theory of pricing, and abandoned the cost basis typical of utility rate regulation. Dual markets were eliminated as well.

With this incentive pricing express provisions were included to insure that the producer received the ceiling price not reduced by severance taxes. This was fully and carefully considered by Congress. It was a significant element in the legislation.

It was understood that under the Act the severance taxes would be passed on to the consumers. Congress thus balanced the considerations among the lessors, lessees, purchasers and the public. This fixed the public policy considerations beyond changes by administrative agencies. *See* Kerr-McGee Corp. v. Northern Utilities, Inc., 673 F.2d 323 (10th Cir.). Congress also set price ceilings and classifications beyond the authority of administrative agencies. The Act thus made fundamental changes in the theory of pricing, the method of pricing, the handling of severance taxes, and the allocation of authority. The Act thereby impacted Interior's formula for royalty calculations.

The Act expressly provided for a treatment of severance taxes and tax reimbursement. This had been an element sought to be used by Interior in its "gross proceeds" concept. The Act also provided that the Commission

could allow adjustments for certain production-related costs which had previously gone into Interior's "gross proceeds." Interior's use of those elements was thus changed by Congress itself. These substantial changes rendered Interior's reliance on its "gross proceeds" untenable. This seems to be demonstrated by the opinion here on appeal where the shift was made away from "gross proceeds," a change to an undefined "value" theory which apparently does not appear in any regulations, letters or memoranda of Interior.

Furthermore the sole basis for the *Wheless* departmental opinion has thus disappeared. A new theory is sought to be substituted. As mentioned, the opinion from which this appeal is taken expresses a departure from *Wheless* and only lip service is given to it. The author of the *Wheless* opinion concurred in the opinion appealed from.

Interior is nevertheless trying to hold on to a position which cannot be reconciled with the NGPA. The consequence is that one agency of Government is seeking to bring about a result contrary to that of another. The intention of Congress in the NGPA is perfectly clear on the point and no room is left for agency action seeking a contrary result or seeking to justify its position on its own concept of "public policy." Congress has resolved the public policy considerations and the issue itself. If Interior prevails in its position, contrary to the NGPA, the producer will have received less than the ceiling price, this by reason of Interior's treatment of severance taxes, an element specifically considered and provided for by Congress.

Interior seeks to increase its royalty amount over the others unfairly by starting with what it refers to as a "value" figure which is in excess of the ceiling price for gas provided by Congress. There is no basis in the NGPA for a separate category for pricing Government royalty gas at a figure different from other gas in the classification. The Government seeks for royalty computation to add to the ceiling price the amount of the severance tax. This it

cannot do. The ceiling price *plus the tax* have no relation to "value". The tax is supposed to be paid, and is paid, according to the state tax statute, by the purchaser. There is no added money going to the producer for the severance tax. There is no such "amount received" by the producer. There is, again, no relation to "value". It is in substance the same as if the Government royalty gas had been sold above the ceiling price contrary to the NGPA.

Again, there is no place in the Congressionally mandated classifications in the NGPA for the separate price category here sought by Interior above the ceiling prices. There is no authority in the administrative agency to create such a classification in at attempt to construct some "value" theory.

Thus it must be concluded that the position of Interior here advanced as to severance taxes is to administratively override the express provisions in the NGPA which do not permit the application of severance taxes to eliminate the right of the producer to the incentive ceiling price. Interior cannot for these or any other purpose create its own price classification.

The arguments advanced by both sides have no impact whatever on the communitization agreement or the unit. We are only concerned with mathematical computations applied to the unit production. There are already distinctions among the tracts because the royalty percentages are different, and by reason of the severance tax exempt status of some production.

The trial court took all these factors into consideration, reached the correct result, and should be affirmed.

APPENDIX B

United States Department of the Interior
GEOLOGICAL SURVEY
6136 East 32nd Place
Tulsa, Oklahoma 74135

Certified Mail
Return Receipt Requested

June 14, 1979

Hoover & Bracken Energies, Inc.
2800 Liberty Tower
Oklahoma City, Oklahoma 73102

Gentlemen:

Subject: Royalty Payments

A review of the transactions in your lease accounts has disclosed that your royalty payments are not based on the gross value of gas sold as reported on your Forms 9-361, Monthly Report of Sales and Royalty. You have failed to include tax reimbursements as part of the gross value when making royalty payment computations. This is in violation of the Oil and Gas Regulations, Chapter 30:221:47.

The gross value basis for payment of royalty was explained in a meeting April 25, 1979, between U.S. Geological Survey personnel and Mr. Charles Nobles of your office, and subsequent telephone conversations with Mr. David Stinson, Attorney. However, we are still receiving royalty payments based on net values (exclusive of tax reimbursements) rather than gross values.

Accordingly, we hereby demand payment of all additional royalties due, within 15 days of receipt of this letter, accompanied by amended Forms 9-614-A, for all Federal and Indian leases owned and/or operated by Hoover & Bracken Energies, Inc. All future royalty payments must be computed on values which include tax reimbursements.

You are advised of your right to appeal this value determination in accordance with the Appeals Procedure set out in 30 CFR 290. If an appeal from this action is taken, it must be filed within the 30-day period specified in 30 CFR.3(a).

Sincerely yours,

F. L. Stelzer
Area Oil and Gas Supervisor

APPENDIX C

United States Department of the Interior
GEOLOGICAL SURVEY
RESTON, VA 22092

GS-148-O&G	:	Oil and gas leases covering
	:	Federal and allotted Indian
IND-20-O&G	:	lands in the State of
	:	Oklahoma
Hoover and Bracken	:	
Energies, Inc.	:	Appeal from an order
	:	requiring the inclusion of tax
	:	reimbursements for royalty
	:	computation purposes
	:	
	:	Affirmed

Appellant

STATEMENT

Hoover and Bracken Energies, Inc. (H&B), is appealing from an order by the Area Oil and Gas Supervisor, Tulsa, Oklahoma, requiring that State excise and gross production taxes be included in the gross value for royalty computation purposes. H&B based its royalty payments on the gross proceeds it received from the sale of such gas, excluding such State taxes.

Section 221.47 of the regulations in 30 CFR provides:

> The value of production, for the purpose of computing royalty shall be the estimated reasonable value of the product as determined by the supervisor, due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices and to other relevant matters. Under no circumstances shall the value of production of any of said substances for purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have

> been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

The royalty provision of the standard form, Oil and Gas Mining Lease for Allotted Indian Lands (Form 5-154h), used by the Bureau of Indian Affairs of the United States Department of the Interior, provides in pertinent part as follows:

> During the period of supervision, 'value' for the purposes hereof may, in the discretion of the Secretary, be calculated on the basis of the highest price paid or offered (whether calculated on the basis of short or actual volume) at the time of production for the major portion of the oil of the same gravity, and gas, and/or natural gasoline, and/or all other hydrocarbon substances produced and sold from the field where the leased lands are situated, and the actual volume of the marketable product less the content of foreign substances as determined by the oil and gas supervisor. The actual amount realized by the lessee from the sale of said products may, in the discretion of the Secretary, be deemed mere evidence of or conclusive evidence of such value.

The language of the royalty provision in the lease tracks the language in the regulations in 25 CFR 172.16.

The State of Oklahoma has levied a tax "* * * equal to seven percent (7%) of the gross value of the production of natural gas * * *." 68 Okl. St. Anno. 1001. By statute, the gross production tax "* * * shall be paid by the purchaser of such products, and such purchaser shall, * * * deduct in making settlements with the producer and/or royalty owner, the amount of tax so paid * * *." 68 Okl. St. Anno.

1009(d). In addition, the State has levied an excise tax equal to 0.085 of 1% "* * * of the gross value of all natural gas and/or casinghead gas produced in the State of Oklahoma which is subject to gross production tax in the State of Oklahoma * * *. "The excise tax shall be paid by the purchaser, who is hereby authorized to deduct in making settlement with the producer and/or royalty owner the amount of tax so paid * * *". 68 Okl. St. Anno. 1102.

In support of its appeal, appellant argues in part:

> The Secretary has indicated that for purposes of the construing the regulation quoted above the word 'value' means fair market value. *California Company* v. *Udall*, 296 F.2d 384, 387 (D.C. Cir. 1961). The fair market value of a commodity ordinarily is defined as the price that would be paid by a willing buyer to a willing seller, neither being under a compulsion to buy or sell. In a totally regulated market, however, value must be further limited by the ceiling price for which such commodity may be sold under the applicable law or regulation. Because the NGPA constitutes total and absolute regulation of the first sale price of *all* natural gas sold in this country, the fair market value of natural gas sold at the wellhead can never exceed the applicable NGPA ceiling price.
>
> In the example above it is evident that H&B is receiving from the Purchaser the maximum lawful price that can be paid under the NGPA for gas produced from the unit. That price is $2.00 per Mcf plus reimbursement of state severance taxes to the extent levied on such production. Because state severance taxes are levied on 15/16 of production from the unit, the Purchaser pays to the Tax Commission 10% of the value of 15/16 of production. Accordingly, H&B realizes $2.00 per Mcf for its share of production and the lessors under the Leases realize $2.00 per Mcf for their royalty share. * * *. It is difficult to imagine how anyone reasonably could conclude that such price does not represent the value of the gas, especially where the Purchaser is absolutely prohibited by law from paying a higher price for *any* portion of the gas.

[APPENDIX]

CONCLUSIONS AND ORDER

Most of the arguments presented by appellant in support of its appeal were previously considered by the Board of Land Appeals (IBLA) in *Wheless Drilling Company*, 13 IBLA 21 (1973). In *Wheless*, the IBLA upheld the Survey's determination stating:

> We recognize that authority to set field prices for natural gas sold in interstate commerce is vested in the Federal Power Commission, by the Natural Gas Act, 15 U.S.C. §§ 717 *et seq.* (1970). We recognize also that the field price established by FPC is not necessarily the 'value of production' as that term is used in the oil and gas operating regulations, 30 CFR 221.47, especially when the additional factor of 'gross proceeds' is considered.
>
> Proceeds and fair market value may not be interchangeable. Proceeds of a sale, unless there is something in the context showing to the contrary, means total proceeds. *United States* v. *Stanolind Crude Oil Purchasing Company*, 113 F.2d 194, 198 (10th Cir. 1940).
>
> The gas purchase contract involving the subject lease, entered into between Arkansas Louisiana Gas, the buyer, and Wheless, the seller, contains a provision in sec. 9 whereby the buyer will reimburse to the seller a specified percentage of any increase in the state severance tax above that in effect on the date of the agreement. The record shows that an increase in the state severance tax was imposed after the date of the contract, effective December 1, 1958, and that the buyer has reimbursed the seller the amounts specified in the sale agreement since that date.
>
> It seems obvious to us that the buyer thus is paying to the seller an amount greater than the established field price for the natural gas it purchases from the #1 T. L. James well. It follows, therefore, that it is reasonable

to compute the Federal royalty of the natural gas taken from this well on a unit value consisting of the field price established by FPC plus the amount of the severance tax reimbursed by the buyer. Within the context of 30 CFR 221.47, 'gross proceeds' means the established field price for the natural gas plus any additional sums paid by the purchaser of the gas to the unit operator as consideration for the purchase of gas from the unit of which the federal lease is a part. In the present case, the unit value for purposes of computing the Federal royalty is $0.132700 plus 63/64 of $0.013333 [$0.013125] or a total of $0.145825 per Mcf. Wheless must comply with the demand by the Oil and Gas Supervisor for payment of additional royalty to the United States on the reimbursed severance tax by the buyer.

California Company v. *Udall*, 296 F. 2d 384 (D.C. Cir. 1961) affirms the right of the Secretary of the Interior to establish 'reasonable price' for royalty purposes. *Kerr-McGee Oil Industries, Inc.*, 70 I.D. 464 (1963), held that the Secretary of the Interior in computing the basic royalty due to the United States under a lease may properly look to the actual consideration to be received by its lessee-seller under gas sales contracts with a buyer in order to determine the proper value basis for the royalty, and a determination by the Geological Survey that a reimbursement to the seller constitutes part of the contract sales price and should be included in the total value basis for the basic royalty computation is proper. We have applied these principles to the case at bar.

The rationale in *Wheless* is equally applicable in the case at bar. The principle applied by IBLA in *Wheless* was that royalty "value" includes the amount of the severance tax paid by the buyer to the seller. Appellant by the buyalleges that the tax here involved is paid directly by the buyer. However, this is not a relevant distinction. The payment of the tax by the buyer inures to the benefit of the seller because H&B "* * * does not have to reach into its

own pocket to pay the severance tax liability." *Amoco Production Co.*, 29 IBLA 234, 237 (March 25, 1977).

Appellant contends that "value" may not include severance tax "reimbursements" in excess of the "maximum lawful price" under the Natural Gas Policy Act of 1978. *Wheless* held that "value" included the severance tax reimbursement in excess of the regulated field price under the Natural Gas Act. The buyer here pays the base price plus the severance tax just as in *Wheless*. Under the leases and the regulations (25 CFR 172.16; 30 CFR 221.47), value may be measured by "* * * the highest price paid * * *." Thus, contrary to appellant's suggestion, the severance tax properly may be included in the royalty value.

The regulated sales price may differ from the fair market value of the production. Thus, under the regulations and the leases, the royalty value is not necessarily equivalent to the amount which would be realized by the Indian allottee or the United States if the royalty were paid in kind for sale by the lessor. In this connection, it might be noted that *Kerr-McGee Oil Industries, Inc.*, 70 I.D. 464, 466 (1963), rejected the contention that the return to the working-interest owners should be the same irrespective of whether the royalty is paid in kind or in value.

It scarcely seems worthy of mention that any inconsistency with State law in this context is irrelevant. The Secretary is not required to conform his method of valuation to any standard other than that provided in the Code of Federal Regulations.

H&B's appeal is hereby denied. This denial is subject to appellant's right, if desired, to appeal to the Interior Board of Land Appeals pursuant to 30 CFR 290 and 43 CFR 4.411. A copy of 43 CFR 4.411 is enclosed for ready reference.

Director

Acting Deputy Commissioner — Indian Affairs
Nov. 29, 1979

APPENDIX D

United States Department of the Interior
OFFICE OF HEARINGS AND APPEALS
INTERIOR BOARD OF LAND APPEALS
4015 Wilson Boulevard
Arlington, Virginia 22203

Hoover & Bracken Energies, Inc.

IBLA 80-305 Decided January 5, 1981

Appeal from decision GS 148-O & G of the Director, Geological Survey and IND 20-O & G of the Acting Deputy Commissioner of the Bureau of Indian Affairs affirming the order of an oil and gas supervisor setting a different basis for computation of the Government's royalty from an oil and gas lease and demanding payment of additional royalty.

Affirmed.

1. Oil and Gas Leases: Royalties

   In determining the amount of royalty due to the United States from an oil and gas lease, it is proper for the Geological Survey to use a base value which includes both the purchase price paid for the natural gas and the amount of severance taxes paid by the purchaser directly to the State where, under Oklahoma law, the purchaser is authorized to deduct the amount of taxes paid from the amount paid to the producer. Decision in *Wheless Drilling Co.*, 13 IBLA 21, 80 I.D. 599 (1973), cited and applied.

APPEARANCES: C. David Stinson, Esq., Bill W. Logsdon, Esq., McAfee, Taft, Mark, Bond, Rucks & Woodruff, Oklahoma City, Oklahoma, for appellant.

OPINION BY ADMINISTRATIVE JUDGE BURSKI

Hoover & Bracken Energies, Inc., has appealed the decision of the Director of the Geological Survey (Survey), and the Acting Deputy Commissioner of the Bureau of Indian Affairs, dated November 29, 1979, affirming an order of the Survey's Area Oil and Gas Supervisor for

Tulsa, Oklahoma. The order required that the value of certain state tax payments be included in the gross value of natural gas sold from appellant's leasehold unit for the purpose of computing Federal royalty payments. Appellant has been basing its royalty payments on the gross proceeds received from the sale of such gas excluding the amount of state taxes.

As authority, the decision cites Departmental regulation, 30 CFR 221.47, which defines the value basis for computing royalties as follows:

> The value of production, for the purpose of computing royalty shall be the estimated reasonable value of the product as determined by the supervisor, due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices and to other relevant matters. Under no circumstances shall the value of productin of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

In addition, the decision quotes the royalty provision of the standard form, Oil and Gas Mining Lease for Allotted Indian Lands (Form 5-154h), used by the Bureau of Indian Affairs of the United States Department of the Interior. That provision reads in pertinent part as follows:

> During the period of supervision, "value" for the purposes hereof may, in the discretion of the Secretary,

> be calculated on the basis of the highest price paid or offered (whether calculated on the basis of short or actual volume) at the time of production for the major portion of the oil of the same gravity, and gas, and/or natural gasoline, and/or all other hydrocarbon substances produced and sold from the field where the leased lands are situated, and the actual volume of the marketable product less the content of foreign substances as determined by the oil and gas supervisor. The actual amount realized by the lessee from the sale of said products may, in the discretion of the Secretary, be deemed mere evidence of or conclusive evidence of such value.

The language of the royalty provision in the lease tracks the language in the regulations in 25 CFR 172.16.

In reaching its decision, Survey relied on the principle enunciated in *Wheless Drilling Co.*, 13 IBLA 21, 80 I.D. 599 (1973), that the value of production for royalty purposes and the term "gross proceeds" includes the amount of severance tax paid by the buyer to the seller of the gas. Survey then concluded that the fact that the buyer in this case paid the tax directly to the State did not change the principle: payment still inured to the benefit of the seller and thus should be considered in computing Federal royalty.

Appellant's leases cover lands which have been communitized with privately owned lands in the same governmental section for the purpose of drilling for and producing oil and gas. Under the communitization agreement, costs are borne by each lessee in the proportion that acreage covered by each lease bears to the total acreage in the unit. Where production occurs, each lessee and royalty owner shares in such production in accordance with the terms of the lease.

The State of Oklahoma has levied "a tax * * * equal to seven percent (7%) of the gross value of the production of natural gas." 68 Okla. Stat. Ann. § 1001 (West). By

statute, the gross production tax "shall be paid by the purchaser of such products and such purchaser shall * * * deduct in making settlements with the producer and/or royalty owner, the amount of tax so paid." 68 Okla Stat. Ann. § 1009(d) (West). The State has also levied an excise tax equal to 0.085 of 1 percent of the "gross value of all natural gas and/or casinghead gas produced in the State of Oklahoma which is subject to gross production tax." The excise tax is also paid by the purchaser who is authorized to deduct the amount of the tax when making settlement with the producer. 68 Okla. Stat. Ann. § 1102 (West). Production derived from restricted Indian lands and lands owned by the United States, to the extent the interest in the production is owned by the restricted Indians or United States, is exempt from taxation. *See* 68 Okla. Stat. Ann. § 1008 (West).

Pursuant to the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. §§ 3301-3432 (Supp. II 1978), the sale of all natural gas produced in the United States is subject to ceiling price limitations. However, section 110(a) of NGPA, 15 U.S.C. § 3320(a) (Supp. II 1978), states that

> a price for the first sale of natural gas shall not be considered to exceed the maximum lawful price applicable to the first sale of such natural gas * * * if such first sale price exceeds the maximum lawful price to the extent necessary to recover —
>
> (1) State severance taxes attributable to the production of such natural gas and borne by the seller * * *.[1]

Appellant informs the Board that it has executed gas purchase contracts covering sale of its interest in production from the unit including the leased lands. Under each contract, the purchaser is required to pay to appellant the maximum lawful price applicable to the gas

---

[1]The definition of "State severance tax" includes "any severance, production, or similar tax, fee or other levy imposed on the production of natural gas" by any State. 15 U.S.C. §3320(c) (Supp. II 1978).

under NGPA and to pay all state severance taxes levied on the gas prior to delivery. Appellant notes that payment of the tax by the purchaser, although not to the lessee, is commonly referred to as "tax reimbursement."

In its statement of reasons, appellant charges that Survey's method for computing royalties is arbitrary, capricious, and an abuse of discretion. Appellant argues that Survey has given no consideration to the "actual value" of the royalty gas. It contends not only that the Board erred in *Wheless*, *supra*, by focusing only on the concept of gross proceeds, but also that the present case is distinguishable from *Wheless* because of the ceiling price limitations set by the NGPA: it argues that reasonable value cannot exceed the ceiling price in a regulated market.

Appellant argues further that the *Wheless* case also stands for the "patently unfair proposition" that the Federal Government may exempt itself from paying state severance taxes on minerals produced from Federal lands and then benefit from such taxes paid by its lessee and all other parties sharing in production from the unit. Appellant suggests that such an outcome is not mandated by any specific statutory authority and such is not a reasonable interpretation of existing regulations.

Finally, appellant suggests that Survey's method for determining royalty is unreasonable because it leads to incongruous results when making certain other comparisons. First, it notes that were the Federal Government to take its royalty share of the gas in kind and then sell it, the value received could be no greater than the ceiling price with no tax reimbursement. Then appellant argues that Survey's method is arbitrary because the identity of the seller of the gas is determinative of its value. Second, appellant points out that Survey's method results in the value of the gas produced from the unit varying according to the size of the acreage in the unit owned by the Federal Government.

[APPENDIX]

[1] It is well recognized that the Secretary of the Interior has considerable latitude in determining what is the "value" of production from a lease on which royalty payments are made. *Amoco Production Co.*, 29 IBLA 234, 236 (1977); *Wheless Drilling Co., supra* at 31; 30 U.S.C. § 226(c) (1976) and 30 U.S.C. § 189 (1976). The Secretary has exercised that discretion by promulgating 30 CFR 221.47 which defines the value basis for computing royalty. In *California Co.* v. *Udall*, 296 F.2d 384 (D.C. Cir. 1961), the Secretary's authority to establish reasonable values for royalty purposes under the Mineral Leasing Act and Departmental regulations was affirmed.

Appellant urges that the Board reconsider its interpretation of 30 CFR 221.47 as set forth in *Wheless, supra.* We decline to do so. In that case we said that the term gross proceeds as used in the regulation "means the established field price for the natural gas plus any additional sums paid by the purchaser of the gas to the unit operator as consideration for the purchase of gas from the unit of which the federal lease is a part." 13 IBLA at 30-31. We held that reimbursement by a purchaser of state severance taxes paid by the seller was an "additional sum" properly included in determining value of production for the purpose of computing royalty under 30 CFR 221.47. *Accord, Amoco Production Co., supra.*

Contrary to appellant's argument, we find that appellant's case, where the price has been set by the NGPA, is no different from that of *Wheless*, where the price was set by the Federal Power Commission (FPC). Appellant attempts to distinguish the two by noting that Wheless Company could elect to sell in the regulated interstate market or the unregulated intrastate market and by arguing that in an unregulated market the fair value *would* be the price paid by the purchaser plus tax reimbursement but in the regulated market the value could never be more than the maximum lawful price for which it may be sold. This is a distinction without substance as applied to this case. Appellant itself

recognizes that the NGPA expressly allows *a price* for the gas to be set *above* the maximum lawful amount to the extent that it reflects state severance taxes paid. 15 U.S.C. § 3320 (Supp. II 1978). Thus regardless of whether we consider the regulated or unregulated market, the amount of tax payments reimbursed does not affect the amount which a producer can receive for its gas under the NGPA. It still may rise to the ceiling. We find that the *Wheless* principle applies equally in either case.

However, the facts of appellant's case are not exactly the same as in *Wheless*, and we feel that further discussion of the regulation as applied to appellant's leases is warranted. We focus particularly on the fact that the applicable Oklahoma statutes provide that the *purchaser* pay the severance taxes and deduct them from the amount paid to the seller. Thus, the amount of the taxes does not result in "proceeds" as that term was used in *Wheless* and is ordinarily understood. We find, however, that appellant has the same ultimate responsibility for the taxes and receives the same benefit under Oklahoma's method of tax collection as it would in a state where the seller is obligated to pay the taxes directly and benefits from reimbursement by the purchaser. Here appellant still receives the benefit of "tax reimbursement" and consequently the value of that benefit may be added to the amount appellant receives to determine the value of production to appellant for the purpose of computing the royalty. As reported by appellant, the amount it receives under its contracts is the NGPA ceiling amount. Since under Oklahoma law a purchaser must deduct the amount of taxes paid to reach the purchase price, we assume that such price reflects the deduction of that amount and therefore the value to appellant of the gas in this case is the ceiling amount plus the tax paid by the purchaser.

If we turn to the question of what is a reasonable value, as appellant argues, and examine the regulation in that context rather than in terms of the *Wheless* principle of

"gross proceeds" and benefit to the producer, we reach the same result. First we note that the regulation, when it refers to gross proceeds, simply sets the minimum value of production and we find that the focus of the regulation in setting the value of production is price. However, Survey may consider "other relevant matters." On this, the relevant portions of the regulation bear repeating:

> The value of production, for the purpose of computing royalty shall be the estimated reasonable value of the product as determined by the supervisor, due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices and to other relevant matters. * * * In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

Thus the value of production as defined by the regulation is not necessarily gross proceeds; *i.e.*, the amount the producer receives from the purchaser for the gas. If that were true, then appellant arguably would be correct that its royalty should be based solely on the NGPA ceiling because that is the amount it receives under its purchase contracts. Under the regulation, however, all of the circumstances of the pricing of the gas may be considered. One such relevant consideration is that, as we have noted, under the NGPA a producer may set a price for gas exceeding the lawful ceiling to the extent of the amount of taxes it must pay. In Oklahoma, appellant's purchaser pays the taxes and technically deducts them from its payment to appellant. As we have already concluded, since appellant receives the ceiling amount, the actual price to the purchaser is the ceiling amount plus the amount of taxes paid. Thus the value of

production is more than the gross proceeds in this case.

Appellant's argument that the value to the United States of the gas produced changes according to whether the producer sells it and pays royalty, or the United States takes it in kind and sells it, is a misleading over simplification of the situation. Appellant presumes that the value to the United States of in kind gas is only what it could then be sold for. If, however, the Government were to take its royalty interest in kind, the implicit assumption would be that it had a use for the gas. The value of this gas is, therefore, properly computed as the price which the United States would pay on the open market if it were purchasing the gas as an ordinary purchaser. The fact that the United States cannot be assessed state severance tax does not depreciate the *value* of the gas to it. Immunity from state taxation is a function of the Federal Government's sovereignty, which prevents the state from assessing a severance tax. This benefit flows to the Government, not the lessor.

The essential fallacy of appellant's argument is made clear if we reverse the instant situation and assume that the seller pays the severance tax. Under section 110(a)(1) of the NGPA, *supra*, the seller would be permitted to obtain reimbursement of the severance tax *above* the established ceiling price. This reimbursement is clearly part of the gross proceeds obtained. The fact that a state may make the purchaser liable for payment of the severance tax does not alter the economic results. In both cases it is the seller who makes the severance and who receives the ceiling price as a net proceed (excluding, of course, other costs of production, which would remain the same no matter how the tax was assessed).

Finally, appellant's argument that the basis of the royalty decreases as the amount of leased Federal or Indian land within a unit increases is merely a mathematical reflection of the fact that as the extent of the Federal royalty interest within a unit rises, an increasing

proportion of unit production is not subject to state taxation. We would point out that appellant's argument would support a finding that the proper mode of determination would not consider any of the lands within a unit as Federally owned.

Using appellant's hypothesis that the NGPA price is $2 per Mcf (such gas having a Btu content of 1,000 Btu/cf), and that the State of Oklahoma imposes a state severance tax equal to 10 percent of the value of all gas produced, one could argue that the value for royalty purposes should be $2.20 per Mcf regardless of the percentage of Federal or Indian lands within the unit. Admittedly, this would not represent "gross proceeds" inasmuch as there would be no severance tax assessed on the Federal or Indian royalty interests, and thus no reimbursement. But such a figure might, nevertheless, arguably represent the real value of an Mcf of gas. "Gross proceeds" is a floor, not a ceiling, concept. Thus, the regulation provides that "[u]nder no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be *less* than the gross proceeds accruing to the lessee from the sale thereof" (emphasis supplied). 30 CFR 221.47. To the extent that the Government has elected to utilize actual gross proceeds in order to determine value, rather than merely applying the percentage severance tax imposed by the State to *all* production had within a unit, the lessees are the beneficiaries.

We agree that the degree of benefit, under the system of value ascertainment adopted by the Geological Survey, will, in fact, vary according to the percentage of Federal and Indian lands within a unit. But inasmuch as the regulation clearly requires that "gross proceeds" serve as the minimum basis for the royalty assessment, the only alternative method would be to ignore "gross proceeds" and proceed on the assumption that all production was subject to severance taxation to determine the value of the gas produced. This would, necessarily, work to the

detriment of every Federal oil and gas lessee.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is affirmed.

James L. Burski
Administrative Judge

We concur:

Bernard V. Parrette
Chief Administrative Judge

Douglas E. Henriques
Administrative Judge

APPENDIX E

UNITED STATES DISTRICT COURT FOR THE
WESTERN DISTRICT OF OKLAHOMA

Filed
Nov. 18 1981
Herbert T. Hope
Clerk, U.S. District Court

HOOVER & BRACKEN ENERGIES, INC., a corporation, Plaintiff	)
vs.	)
	) NO. CIV-81-461-T
UNITED STATES DEPARTMENT OF THE INTERIOR; JAMES G. WATT, Secretary, United States Department of the Interior; DOYLE G. FREDERICK, Acting Director, United States Geological Survey; and THEODORE KRENZKE, Deputy Commissioner of the Bureau of Indian Affairs, Defendants.	)

MEMORANDUM OPINION

This action is before the Court for consideration of defendants' Motion to Dismiss and plaintiff's Motion for Summary Judgment. The parties have fully briefed the issues presented by the motions. In responding in opposition to the defendants' Motion to Dismiss, plaintiff treated the motion as one for summary judgment pursuant to Rule 56, F.R.Civ.P. The Court agrees that defendants' motion must be treated as a Motion for Summary Judgment and, so treated, rules upon the cross motions for summary judgment as follows:

[APPENDIX]

Plaintiff commenced this action seeking judicial review of a final administrative action of the Department of the Interior, implemented by the Interior Board of Land Appeals. Plaintiff asserts the subject matter jurisdiction of this Court pursuant to the Administrative Procedure Act, 5 U.S.C. §§ 702-706, and 28 U.S.C. §§ 1331, 1361, 2201, and 2202.

The facts of this action, as stated by the administrative judge writing for the Interior Board of Land Appeals, are as follows:

> "Hoover & Bracken Energies, Inc., has appealed the decision of the Director of the Geological Survey (Survey), and the Acting Deputy Commissioner of the Bureau of Indian Affairs, dated November 29, 1979, affirming an order of the Survey's Area Oil and Gas Supervisor for Tulsa, Oklahoma. The order required that the value of certain state tax payments be included in the gross value of natural gas sold from appellant's leasehold unit for the purpose of computing Federal royalty payments. Appellant has been basing its royalty payments on the gross proceeds received from the sale of such gas excluding the amount of state taxes.
>
> As authority, the decision cites Departmental regulation, 30 CFR 221.47, which defines the value basis for computing royalties as follows:
>
> > The value of production, for the purpose of computing royalty shall be the estimated reasonable value of the product as determined by the supervisor, due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from

> the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

In addition, the decision quotes the royalty provision of the standard form, Oil and Gas Mining Lease for Allotted Indian Lands (Form 5-154h), used by the Bureau of Indian Affairs of the United States Department of the Interior. That provision reads in pertinent part as follows:

> During the period of supervision, 'value' for the purposes hereof may, in the discretion of the Secretary, be calculated on the basis of the highest price paid or offered (whether calculated on the basis of short or actual volume) at the time of production for the major portion of the oil of the same gravity, and gas, and/or natural gasoline, and/or all other hydrocarbon substances produced and sold from the field where the leased lands are situated, and the actual volume of the marketable product less the content of foreign substances as determined by the oil and gas supervisor. The actual amount realized by the lessee from the sale of said products may, in the discretion of the Secretary, be deemed mere evidence of or conclusive evidence of such value.

The language of the royalty provision in the lease tracks the language in the regulations in 25 CFR 172.16.

In reaching its decision, Survey relied on the principle

enunciated in *Wheless Drilling Co.*, 13 IBLA 21, 80 I.D. 599 (1973), that the value of production for royalty purposes and the term 'gross proceeds' includes the amount of severance tax paid by the buyer to the seller of the gas. Survey then concluded that the fact that the buyer in this case paid the tax directly to the State did not change the principle: payment still inured to the benefit of the seller and thus should be considered in computing Federal royalty.

Appellant's leases cover lands which have been communitized with privately owned lands in the same governmental section for the purpose of drilling for and producing oil and gas. Under the communitization agreement, costs are borne by each lessee in the proportion that acreage covered by each lease bears to the total acreage in the unit. Where production occurs, each lessee and royalty owner shares in such production in accordance with the terms of the lease.

The State of Oklahoma has levied 'a tax * * * equal to seven percent (7%) of the gross value of the production of natural gas.' 68 Okla. Stat. Ann. § 1001 (West). By statute, the gross production tax 'shall be paid by the purchaser of such products and such purchaser shall * * * deduct in making settlements with the producer and/or royalty owner, the amount of tax so paid.' 68 Okla. Stat. Ann. § 1009(d) (West). The state has also levied an excise tax equal to 0.085 of 1 percent of the 'gross value of all natural gas and/or casinghead gas produced in the State of Oklahoma which is subject to gross production tax.' The excise tax is also paid by the purchaser who is authorized to deduct the amount of the tax when making settlement with the producer. 68 Okla. Stat. Ann. § 1102 (West). Production derived from restricted Indian lands and lands owned by the United States, to the extent the interest in the production is owned by the restricted Indians or United States, is exempt from taxation. *See* 68 Okla. Stat. Ann. § 1008 (West).

Pursuant to the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. §§ 3301-3432 (Supp. II 1978), the sale of all natural gas produced in the United States is subject to ceiling price limitations. However, Section 110(a) of NGPA, 15 U.S.C. § 3320(a) (Supp. II 1978), states that

> a price for the first sale of natural gas shall not be considered to exceed the maximum lawful price applicable to the first sale of such natural gas * * * if such first sale price exceeds the maximum lawful price to the extent necessary to recover —
>
> > (1) State severance taxes attributable to the production of such natural gas and borne by the seller * * * .[1]

Appellant informs the Board that it has executed gas purchase contracts covering sale of its interest in production from the unit including the leased lands. Under each contract, the purchaser is required to pay to appellant the maximum lawful price available to the gas under NGPA and to pay all state severance taxes levied on the gas prior to delivery. Appellant notes that payment of the tax by the purchaser, although not to the lessee, is commonly referred to as 'tax reimbursement.' "

The Interior Board of Land Appeals concluded that the principle stated in *Wheless Drilling Co.*, supra, applied to the plaintiff and that plaintiff was therefore required to account for the defendants' royalty share of production at a value including the state severance taxes in addition to the contract price. In reaching its decision, the Interior Board of Land Appeals commented that "appellant's case, where the price has been set by the NGPA, is no different from that of *Wheless*, where the price was set by

---

[1]The definition of "State severance tax" included "any severance, production or similar tax, fee, or other levy imposed on the production of natural gas" by any state. 15 U.S.C. §3320(c) (Supp. II 1978).

the Federal Power Commission (FPC) ... Thus regardless of whether we consider the regulated or unregulated market, the amount of tax payments reimbursed does not affect the amount which a producer can receive for its gas under the NGPA. It may still rise to the ceiling. We find that the *Wheless* principle applies equally in either case." 52 ILBA at 34. The sole question presented here is whether *Wheless* is controlling.

At the time *Wheless* was decided, there existed two separate, and quite distinct, gas markets in this country; the federally regulated interstate market; and the unregulated intrastate market. If gas was dedicated to the interstate market, it could not later be sold on the unregulated interstate market. Thus, the value of the gas that was produced was closely related to the market within which it was sold. Under this system, the value of production, as determined pursuant to 30 C.F.R. § 221.47, was the price a purchaser in the field would be willing to pay for the gas produced. The *Wheless* decision merely holds that if the purchaser is willing to assume the costs of any state severance taxes, regardless of who the state requires payment from, then the cost of those taxes represent a part of the value of the gas sold.

In *Wheless Drilling Company*, 13 IBLA 21 (1973), the Interior Board of Land Appeals stated:

> "We recognize that authority to set field prices for natural gas sold in interstate commerce is vested in the Federal Power Commission, by the Natural Gas Act, 15 U.S.C. §§ 717 *et seq.* (1970). We recognize also that the field price established by FPC is not necessarily the 'value of production' as that term is used in the oil and gas operating regulations, 30 C.F.R. § 221.47, especially when the additional factor of 'gross proceeds' is considered.
>
> Proceeds and fair market value may not be interchangeable. Proceeds of a sale, unless there is something in the context showing to the contrary,

means total proceeds. *United States v. Stanolind Crude Oil Purchasing Company*, 113 F.2d 194, 198 (10th Cir. 1940)."

Under the Natural Gas Policy Act, Congress has established maximum ceiling prices for natural gas that apply uniformly nationwide. In order to achieve this national uniformity of maximum price to the seller, Congress has determined that regardless of who a state happens to impose the burden of paying any severance taxes upon, the seller is still entitled to receive up to the maximum ceiling price. Thus, Congress has shifted the ultimate responsiblility for payment of the state severance taxes to the consumers of the gas produced.

The Natural Gas Policy Act is clear that the maximum lawful price of natural gas may be exceeded to the extent that state severance taxes are *borne by the seller*. Inasmuch as the gas quantities here disputed were not subject to state severance taxes, the value of the United States' share of the production is the maximum lawful price of gas under the Natural Gas Policy Act. To the extent that the United States interprets its regulations in a manner designed to place a value upon its share of the production that is in excess of the maximum lawful price, such interpretation is contrary to the expressed provisons of the law. It is simply beyond the executive's lawful authority to value its share of the gas production at a price in excess of the maximum lawful price established by Congress. To the extent that the United States has interpreted *Wheless* to require the plaintiff to account for the United States' share of production as though the United States is entitled to sell its share of production at an illegal rate, the interpretation is contrary to law and therefore void. Accordingly, the defendants' Motion to Dismiss, treated as a Motion for Summary Judgment is hereby denied. The plaintiff's Motion for Summary Judgment is hereby granted.

DATED this 18th day of November, 1981.

Ralph G. Thompson
UNITED STATES DISTRICT JUDGE

APPENDIX F

IN THE UNITED STATES DISTRICT COURT FOR THE
WESTERN DISTRICT OF OKLAHOMA

Filed
Nov. 18 1981
Herbert T. Hope
Clerk, U.S. District Court

HOOVER & BRACKEN ENERGIES, INC., a corporation,
Plaintiff

vs.

NO. CIV-81-461-T

UNITED STATES DEPARTMENT OF THE INTERIOR; JAMES G. WATT, Secretary, United States Department of the Interior; DOYLE G. FREDERICK, Acting Director, United States Geological Survey; and THEODORE KRENZKE, Deputy Commissioner of the Bureau of Indian Affairs,
Defendants.

JUDGEMENT

In accordance with the Court's Memorandum Opinion and Order entered this date, judgment is hereby entered in favor of the plaintiff and against the defendants whereby the Interior Board of Land Appeals decision dated January 5, 1981, IBLA 80-305, Hoover & Bracken Energies, Inc., is null and void and the United States Geological Survey is ordered to refund payments of the disputed amounts made by Hoover & Bracken Energies, Inc.

DATED this 18th day of November, 1981.

Ralph G. Thompson
UNITED STATES DISTRICT JUDGE
Entered in judgment docket Nov. 18, 1981

APPENDIX G

JANUARY TERM — February 3, 1984

Before Honorable Oliver Seth, Honorable Robert H. McWilliams, Honorable James E. Barrett, Honorable William E. Doyle, Honorable Monroe G. McKay, Honorable James K. Logan, and Honorable Stephanie K. Seymour, Circuit Judges

---

HOOVER & BRACKEN ENERGIES, INC., a corporation, Plaintiff-Appellee	)	
vs.	)	NO. 82-1074
UNITED STATES DEPARTMENT OF THE INTERIOR, *et al.*, Defendants-Appellants.	)	
SHELL OIL COMPANY, Amicus Curiae.	)	

This matter comes on for consideration of appellee's petition for rehearing and suggestion for rehearing en banc in the captioned case.

Upon consideration whereof, the petition for rehearing is denied by Circuit Judges McWilliams and Doyle. Chief Judge Seth voted to grant rehearing.

The Court having been polled on the suggestion for rehearing en banc, Rule 35, Federal Rules of Appellate Procedure, rehearing en banc is denied by Circuit Judges McWilliams, Doyle, McKay and Seymour. Circuit Judges Seth, Barrett and Logan voted to grant rehearing. Circuit Judge William J. Holloway, Jr., did not participate.

HOWARD K. PHILLIPS, Clerk
by Robert L. Hoecker
Chief Deputy Clerk

APPENDIX H

SEC. 110. TREATMENT OF STATE SEVERANCE TAXES AND CERTAIN PRODUCTION-RELATED COSTS.

(a) ALLOWANCE FOR STATE SEVERANCE TAXES AND CERTAIN PRODUCTION-RELATED COSTS. — Except as provided in subsection (b), a price for the first sale of natural gas shall not be considered to exceed the maximum lawful price applicable to the first sale of such natural gas under this subtitle if such first sale price exceeds the maximum lawful price to the extent necessary to recover —

(1) State severance taxes attributable to the production of such natural gas and borne by the seller, but only to the extent the amount of such taxes does not exceed the limitation of subsection (b); and

(2) any costs of compressing, gathering, processing, treating, liquefying, or transporting such natural gas, or other similar costs, borne by the seller and allowed for, by rule or order, by the Commission.

APPENDIX I

§ 221.47 Value basis for computing royalties.

The value of production, for the purpose of computing royalty shall be the estimated reasonable value of the product as determined by the supervisor, due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

APPENDIX J

§ 172.16 Rentals and royalties for oil and gas leases.

The lessee shall pay, beginning with the date of approval of oil and gas leases by the Secretary of the Interior, a rental of $1.25 per acre per annum in advance during the continuance thereof, the rental so paid for any one year to be credited on the royalty for that year, together with a royalty of 12 1/2 percent of the value or amount of all oil, gas, and/or natural gasoline, and/or all other hydrocarbon substances produced and saved from the land leased save and except oil, and/or gas used by the lessee for development and operation purposes on the lease, which oil or gas shall be royalty free. A higher rate of royalty may be fixed by the Secretary of the Interior or his authorized representative, prior to the advertisement of land for oil and gas leases. During the period of supervision, "value" for the purposes of the lease may, in the discretion of the Secretary, be calculated on the basis of the highest price paid or offered (whether calculated on the basis of short or actual volume) at the time of production for the major portion of the oil of the same gravity, and gas, and/or natural gasoline, and/or all other hydrocarbon substances produced and sold from the field where the leased lands are situated, and the actual volume of the marketable product less the content of foreign substances as determined by the oil and gas supervisor. The actual amount realized by the lessee from the sale of said products may, in the discretion of the Secretary of the Interior, be deemed mere evidence of or conclusive evidence of such value. When paid in value, such royalties shall be due and payable monthly on the last day of the calendar month following the calendar month in which produced; when royalty on oil produced is paid in kind, such royalty oil shall be delivered in tanks provided by the lessee on the premises where produced without cost to the lessor unless otherwise agreed to by the parties thereto, at such time as may be required by the

lessor. The lessee shall not be required to hold such royalty oil in storage longer than 30 days after the end of the calendar month in which said oil is produced. The lessee shall be in no manner responsible or held liable for loss or destruction of such oil in storage caused by acts of God. All rental and royalty payments, except as provided in sections 4(c) and 8(a) of the lease (Form 5-154h, revised April 24, 1935), shall be made by check or draft drawn on a solvent bank, open for the transaction of business on the day the check or draft is issued, to the order of the Superintendent. Except the advance rental for the first year, which, as provided in § 212.14 shall be paid to the superintendent when the lease is filed, payments shall be transmitted through the oil and gas supervisor, shall be accompanied by a statement by the lessee, in triplicate, showing the specific items of rental or royalty that the remittance is intended to cover, and shall be made at such times as the lease provides. In determining the value for royalty purposes of products, such as natural gasoline, that are derived from treatment of gas, a reasonable allowance for the cost of manufacture shall be made, such allowance to be two-thirds of the value of the marketable product unless otherwise determined by the Secretary of the Interior on application of the lessee or on his own initiative, and that royalty will be computed on the value of gas or casing-head gas, or on the products thereof (such as residue gas, natural gasoline, propane, butane, etc.), whichever is the greater.

Office-Supreme Court, U.S.
FILED
AUG 15 1984
ALEXANDER L. STEVAS,
CLERK

No. 83-1792

In the Supreme Court of the United States

OCTOBER TERM, 1984

HOOVER & BRACKEN ENERGIES, INC., PETITIONER

v.

UNITED STATES DEPARTMENT OF THE INTERIOR, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

REX E. LEE
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QUESTIONS PRESENTED

1. Whether the Secretary of the Interior's method of calculating royalties for gas produced from federal and allotted Indian lands is prohibited by the Natural Gas Policy Act of 1978, 15 U.S.C. 3301 *et seq.*

2. Whether the Secretary's method of royalty calculation is based on an arbitrary and capricious interpretation of 25 C.F.R. 172.16 (1981) and 30 C.F.R. 221.47 (1982) and is otherwise contrary to law.

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In the Supreme Court of the United States

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HOOVER & BRACKEN ENERGIES, INC., PETITIONER

v.

UNITED STATES DEPARTMENT OF THE INTERIOR, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A13) is reported at 723 F.2d 1488. The opinion of the district court (Pet. App. E1-E7) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on December 28, 1983. A petition for rehearing was denied on February 3, 1984 (Pet. App. G), and the petition for a writ of certiorari was filed on May 3, 1984. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. The State of Oklahoma imposes two severance taxes on natural gas produced within the State: a gross production tax of 7% of the gross value of the production of natural gas (Okla. Stat. Ann. tit. 68, § 1001(b) (West Supp. 1983)), and an excise tax equal to .085% of the gross value of

all natural gas produced within the State subject to the state gross production tax (*id.* § 1102). Both taxes are required to be paid to the Oklahoma Tax Commission by the purchaser of the natural gas, who is authorized to deduct the taxes paid from the payments due to the producer and/or royalty owner (*id.* §§ 1009(d), 1102). The royalty share of the natural gas produced from federal and restricted Indian lands is exempt from both the gross production tax and the excise tax (*id.* § 1008 and *id.* § 1106 (1966)).[1]

The Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. 3301 *et seq.*, establishes ceiling prices for all natural gas produced and sold in the United States (with the exception of certain categories of high-cost gas not at issue in this case). Section 110(a)(1) of the NGPA, 15 U.S.C. 3320(a)(1), permits the applicable ceiling price to be exceeded to the extent necessary to recover "State severance taxes attributable to the production of such natural gas and borne by the seller * * *."

2. Petitioner is an independent producer of oil and gas and holds interests as lessee in several oil and gas leases of federal and allotted Indian lands in western Oklahoma. These federal and Indian lands have been communitized with privately-owned lands.[2] Petitioner's leases of

---

[1]Thus, if the federal government were to own a royalty interest of ⅛ of the natural gas produced from its leasehold, the purchaser would pay severance taxes on ⅞ of that production. See Pet. App. D4.

[2]Under the government-approved communitization agreements, all land included within one drilling and spacing unit, as established by state law, is developed as though the land were under one lease. Communitization allows production from one well within the unit to constitute production from each lease within the unit. Costs are borne by each lessee according to the percentage of the total acreage in the unit leased, and production from the unit is allocated to each lessee and royalty owner-lessor in accordance with the terms of the lease. See Pet. App. A9 n.5, D3, E4.

non-Indian federal lands provide that a royalty of 12-½% on production shall be computed pursuant to 30 C.F.R. 221.47 (1982),[3] which provides as follows:

> The value of production, for the purpose of computing royalty shall be the estimated reasonable value of the product as determined by the supervisor, due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

The leases of allotted Indian lands incorporate 25 C.F.R. 172.16 (1981),[4] which provides for a royalty of 16-2/3% of the "value" of the natural gas produced, as determined by the Secretary of the Interior:

> During the period of supervision, "value" for the purposes of the lease may, in the discretion of the Secretary, be calculated on the basis of the highest price paid or offered (whether calculated on the basis of short or

---

[3]This regulation has been redesignated as 30 C.F.R. 206.103 (1983).

[4]This regulation has been redesignated as 25 C.F.R. 212.16 (1983).

> actual volume) at the time of production for the major portion of the oil of the same gravity, and gas, and/or natural gasoline, and/or all other hydrocarbon substances produced and sold from the field where the leased lands are situated, and the actual volume of the marketable product less the content of foreign substances as determined by the oil and gas supervisor. The actual amount realized by the lessee from the sale of said products may, in the discretion of the Secretary of the Interior, be deemed mere evidence of or conclusive evidence of such value.

Petitioner sells the natural gas produced from the communitized units under long-term contracts that require the purchasers to pay petitioner the applicable NGPA ceiling price and to pay directly to the State Tax Commission all state severance taxes levied on the gas. Petitioner paid the royalties due under the federal and Indian leases based on the NGPA ceiling price it received for the gas, without including in the royalty calculation the state severance taxes paid by the purchasers.

3. By letter dated June 14, 1979 (Pet. App. B), the Area Oil and Gas Supervisor (the Supervisor) of the United States Geological Survey (USGS) notified petitioner that royalty payments must be based on the "gross value" of the gas sold, and that "gross value" includes the taxes paid by the purchasers; the supervisor demanded payment for past and future royalties calculated accordingly. Petitioner's initial appeal of the Supervisor's determination was denied by a tribunal composed of the Acting Director, USGS, and the Acting Deputy Commissioner, Bureau of Indian Affairs (Pet. App. C1-C6).[5]

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[5]The administrative tribunal relied on the decision of the Interior Board of Land Appeals in *Wheless Drilling Co.*, 13 I.B.L.A. 21 (1973), which established that "value" for royalty computation purposes

Petitioner then appealed to the Interior Board of Land Appeals (IBLA), which affirmed the previous administrative determinations (Pet. App. D1-D11). Recognizing that "the Secretary of the Interior has considerable latitude in determining what is the 'value' of production from a lease on which royalty payments are made" (*id.* at D6), the IBLA rejected the argument that the value of production, for royalty computation purposes, could not include the amount of severance taxes paid by the purchasers. The IBLA noted that "the NGPA expressly allows a price for the gas to be set above the maximum lawful amount to the extent that it reflects state severance taxes paid" (*id.* at D7; emphasis omitted). Although it recognized that under Oklahoma law, it is the purchaser, rather than the seller, who pays the severance taxes to the State Commission, the IBLA pointed out that the state law permits the purchaser to deduct the severance taxes from the amount paid to the seller. Accordingly, the IBLA concluded (*ibid.*) that

> [petitioner] has the same ultimate responsibility for the taxes and receives the same benefit under Oklahoma's method of tax collection as it would in a state where the seller is obligated to pay the taxes directly and benefits from reimbursement by the purchaser. Here [petitioner] still receives the benefit of "tax reimbursement" and consequently the value of that benefit may be added to the amount [petitioner] receives to determine the value of production to [petitioner] for the purpose

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includes the amount of the severance tax paid by the buyer to the seller. Although noting that the taxes involved in this case are paid by the buyer directly to the state tax commission, the tribunal concluded that this is not a relevant distinction, reasoning that "[t]he payment of the tax by the buyer inures to the benefit of the seller because [petitioner] '* * * does not have to reach into its own pocket to pay the severance tax liability' " (Pet. App. C5-C6, quoting from *Amoco Production Co.*, 29 I.B.L.A. 234, 237 (1977)).

> of computing the royalty. As reported by [petitioner], the amount it receives under its contracts is the NGPA ceiling amount. Since under Oklahoma law a purchaser must deduct the amount of taxes paid to reach the purchase price, we assume that such price reflects the deduction of that amount and therefore the value to [petitioner] of the gas in this case is the ceiling amount plus the tax paid by the purchaser.

4. Petitioner filed this action in the United States District Court for the Western District of Oklahoma, seeking judicial review of the IBLA decision. The district court granted petitioner's motion for summary judgment (Pet. App. E1-E7, F). The court noted that under the NGPA, "the maximum lawful price of natural gas may be exceeded to the extent that state severance taxes are *borne by the seller*" (*id.* at E7; emphasis in original). It concluded (*ibid.*): "To the extent that the United States interprets its regulations in a manner designed to place a value upon its share of the production that is in excess of the maximum lawful price, such interpretation is contrary to the expressed provisions of the law."

The court of appeals reversed (Pet. App. A1-A13). It held that the IBLA's earlier decision in *Wheless Drilling Co.*, 13 I.B.L.A. 21 (1973), which was decided under the Natural Gas Act, 15 U.S.C. 717 *et seq.*, and which upheld the inclusion of tax reimbursements as part of the value of production for royalty computation purposes, was not rendered inapplicable by the enactment of the NGPA (Pet. App. A4-A8). In this regard, the court pointed out that Section 110(a) of the NGPA, 15 U.S.C. 3320(a), allows the statutory ceiling price to be exceeded to the extent necessary to recover state severance taxes (Pet. App. A8). The court concluded that the Secretary's decision to calculate the value of production on the basis of the NGPA ceiling price

plus any severance taxes paid by the purchaser is consistent with the statutory scheme of the NGPA (*id.* at A10).[6]

ARGUMENT

The decision of the court of appeals upholding the Secretary's determination of value of natural gas production for royalty computation purposes is correct and, this case being one of first impression, does not conflict with any decision of this Court or any other court of appeals. Accordingly, review by this Court is not warranted.

1. Petitioner argues (Pet. 7-12) that the Secretary's method of royalty calculation is inconsistent with the ceiling price and severance tax reimbursement scheme established by Congress under the NGPA. The Secretary has required that the amount of severance tax "reimbursed" to petitioner from the purchasers be taken into account in calculating the value of the natural gas produced for royalty computation purposes.[7] Petitioner apparently concedes (Pet. 8 n.13) that the NGPA would not bar a producer and a private lessor from entering into an agreement for calculating royalties on the basis of the total value of the production, including the NGPA ceiling price plus any state severance tax reimbursement. Petitioner contends (Pet. 10),

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[6]Judge Seth dissented (Pet. App. A11-A13). He concluded that, because the state severance tax is paid by the purchaser directly to the state and not to the producer, the tax has no relation to value (*id.* at A13).

[7]As noted above, Section 110(a) of the NGPA, 15 U.S.C. 3320(a), permits producers to charge in excess of the applicable ceiling price in order to recover state severance taxes borne by *the seller*. Under Oklahoma law, however, the severance taxes are paid directly by the purchaser, who is entitled to deduct those taxes from the payments due to the producer and/or royalty owner. The IBLA correctly concluded (Pet. App. D7, D9) that the fact that the purchaser is liable for payment of the tax does not alter the economic result. Thus, the Oklahoma severance tax scheme is the economic equivalent of the more typical tax reimbursement system permitted by Section 110(a) of the NGPA. Petitioner does not appear to dispute this point.

however, that "[w]here a portion of tax reimbursement costs * * * is appropriated by a tax exempt royalty owner, it is clear that the statutory purpose in allowing the ceiling price to be exceeded under Section 110 is thwarted." This contention is without merit.

One of the primary purposes of the NGPA was the "establishment of a statutory incentive price structure that would simultaneously promote production and reduce the regulatory burden * * *." *Public Service Commission* v. *Mid-Louisiana Gas Co.*, No. 81-1889 (June 28, 1983), slip op. 11. Title I of the NGPA defines eight categories of natural gas production and specifies the maximum lawful price that may be charged for "first sales" in each category. *Mid-Louisiana Gas Co.*, slip op. 2. Section 110(a) of the NGPA provides that a seller who includes in his price an amount necessary to recover state severance taxes "shall not be deemed to have exceeded the federal price ceiling if he would not have exceeded it had that amount not been included." *Exxon Corp.* v. *Eagerton*, No. 81-1020 (June 8, 1983), slip op 7.

The NGPA, however, does not expressly address the issue of royalties. And there is nothing in the Act or its legislative history that suggests that the government, as lessor of gas-producing properties, may not assign, as the value of production for royalty purposes, the maximum NGPA ceiling price plus the amount of tax reimbursement paid by the purchaser for gas produced from government leaseholds. The only relationship between the NGPA's incentive pricing scheme and the Secretary's royalty calculation method is that petitioner pays royalties to the government out of the proceeds it receives from the sale of gas, which proceeds include the severance tax reimbursement. Of course, every royalty payment decreases the amount of net proceeds and thus lessens the incentive to

produce and sell gas. But it does not necessarily follow that such royalty payments are thereby subject to challenge as being contrary to the congressional policy underlying the NGPA.[8]

At bottom, petitioner's argument appears to be that the Secretary's royalty calculation method is somehow "unfair" because it permits the government to benefit from the tax reimbursements paid on the portion of the production in which the government has no royalty interest (see Pet. 15-16). But there is nothing in the NGPA that prevents the government from collecting a royalty on the total value of the production from its leasehold. Although the government's royalty interest (like the interest of a private royalty owner) is set at a fixed percentage of production, the NGPA does not require the "value" of that production to be determined by looking only to the percentage of production in which the government (or private royalty owner) has an interest. On the contrary, the royalty may be based on the "value" (in this case, the NGPA price plus any tax reimbursements) of *all* the gas produced from the leasehold.

2. Petitioner also argues (Pet. 17-20) that the Secretary's interpretation of his own regulations (25 C.F.R. 172.16 (1981) and 30 C.F.R. 221.47 (1982)) in determining the value of production for royalty computation purposes is arbitrary, capricious and unreasonable because it produces different results depending on the identity of the seller, the

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[8]We note that this is not a case in which the royalty owner has sought to impute a value to the gas for royalty purposes at a level exceeding the maximum lawful price applicable to that gas. See Pet. App. A6. Thus, there is no need for the Court to hold this case pending its disposition of the petitions for a writ of certiorari in *Ashland Oil, Inc.* v. *Good*, No. 83-1234; *Mobil Oil Corp.* v. *Batchelder*, No. 83-1248; *Kewanee Oil Co.* v. *Holmes*, No. 83-1250; and *Cities Service Oil Co.* v. *Matzen*, No. 83-1278.

tax jurisdiction in which the lands are situated, and the percentage of federal or restricted Indian lands included within the producing unit.

It is well settled that, to sustain an agency's construction of a term in a statute it administers, a court need not find that the agency's construction is the only reasonable one, or even that it is the construction the court would have chosen had the question first arisen in judicial proceedings. See *Chevron U.S.A., Inc.* v. *Natural Resources Defense Council, Inc.*, No. 82-1005 (June 25, 1984), slip op. 4-7. Moreover, "[a]n agency's construction of its own regulations has been regarded as especially due [considerable] respect." *Ford Motor Credit Co.* v. *Milhollin*, 444 U.S. 555, 566 (1980). See *Udall* v. *Tallman*, 380 U.S. 1, 16 (1965).

The leases of both federal lands and allotted Indian lands involved in this case provide that the Secretary or his delegate shall establish the value of production for royalty purposes. The leases also incorporate the applicable regulations for federal and Indian lands, which list the various factors the Secretary should consider in determining the value of production. It is clear that the Secretary's royalty calculation method is sanctioned by the regulations. With regard to federal lands, the Secretary is given broad discretion to consider not only the gross proceeds received by the lessee, but also "the highest price paid for a part or for a majority of production of like quality in the same field" as well as "other relevant matters." 30 C.F.R. 221.47 (1982).[9] The Secretary's method of calculating royalties based upon the gross proceeds received by petitioner for gas produced from (or attributable to) the government leaseholds — *i.e.*,

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[9]The leases of Indian lands and 25 C.F.R. 172.16 (1981) contain similar language, and petitioner has not contended that the federal and Indian leases should be construed differently.

the applicable NGPA price plus severance tax reimbursement — is a reasonable application of the regulations at issue. Indeed, as the IBLA pointed out (Pet. App. D10-D11):

> inasmuch as the regulation clearly requires that "gross proceeds" serve as the minimum basis for the royalty assessment, the only alternative method would be to ignore "gross proceeds" and proceed on the assumption that all production was subject to severance taxation to determine the value of the gas produced. This would, necessarily, work to the detriment of every Federal oil and gas lessee.

Petitioner contends (Pet. 17-18) that the Secretary's method is arbitrary and unreasonable because, if the government were to take "in kind" its royalty share of gas produced from its leasehold and then sell it, it could receive only the NGPA ceiling price by virtue of the fact that its interest in the production is tax-exempt. This argument, however, assumes that the "value" to the United States of "in kind" gas is necessarily equivalent to the price it could command upon the sale of that gas. This assumption was correctly rejected by the IBLA (Pet. App. D9):

> If, however, the Government were to take its royalty interest in kind, the implicit assumption would be that it had a use for the gas. The value of this gas is, therefore, properly computed as the price which the United States would pay on the open market if it were purchasing the gas as an ordinary purchaser.

The price the government would pay to receive gas of like quality to "in kind" gas in the present case would include both the NGPA ceiling price and the state severance tax.

Petitioner also contends (Pet. 18-20) that the Secretary's method is arbitrary and capricious because the total amount of royalties due the lessors in a communitized unit

will vary according to the tax jurisdiction in which the lands are situated and the percentage of federal or Indian land within the unit. In both situations, however, the differences in royalty are the direct result of the tax-exempt status of the federal and Indian royalty interest in the gas (see Pet. App. D9-D10).[10] The immunity from state taxation is a function of federal sovereignty and, as such, is a benefit that should accrue to the government. As noted by the IBLA, "[t]he fact that the United States cannot be assessed state severance tax does not depreciate the *value* of the gas to it" (Pet. App. D9; emphasis in original).

In sum, when petitioner leased the federal and Indian lands at issue, it agreed that the Secretary would have the discretion to determine the value of natural gas production for royalty purposes. The Secretary's method of royalty calculation constitutes a reasonable exercise of that discretion.

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[10]The percentage of Indian or federal land within a given communitization unit is determined by the land needed to drill an oil and gas well and is beyond the control of the Secretary. The government collects royalties only on the production allocated to the federal or Indian land within the unit; accordingly, the tax exempt portion generally remains constant as a percentage of the production so allocated, the only variation occurring as a result of different royalty rates in the federal or Indian leases. The lands needed for a communitization unit and the applicable royalty rates are standard elements of doing business in the oil and gas industry and are not unique to Indian or federal leases.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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